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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 477

RKO GENERAL, INC.,

Petitioner,

—v.—

MARGOT NEWMARK,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner RKO General, Inc., respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit in the above-captioned case.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 425 F.2d 348 and also in CCH Fed. Sec. L. Rep. ¶ 92,650. That opinion is reprinted as Appendix A hereto, pp. 1a to 18a, *infra*. The opinions of the District Court for the Southern District of New York with respect to liability (Tyler, J.) and damages approximating $8 million (Bonsal, J.) are reported at 294 F. Supp. 358 and at 305 F. Supp. 310, respectively, and are reprinted as Appendices B and C hereto, pp. 19a to 51a, *infra*.

JURISDICTION

The judgment of the Court of Appeals was entered on April 30, 1970. (Appendix E, p. 54a, *infra*.) A timely petition for rehearing or, alternatively, for rehearing en banc was denied June 2, 1970. (Appendix D, p. 52a, *infra*.) The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1). The basis of jurisdiction in the District Court was Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa.

QUESTIONS PRESENTED

1. Within the meaning of Section 16(b) of the Securities Exchange Act of 1934, which provides for forfeiture of profits realized on the short-swing "purchase and sale" of securities, does the filing of a plan of statutory merger of two publicly owned companies constitute a "sale" of securities of the merged company by the shareholders of that company where (i) all shareholders of each merging company are treated alike, and (ii) the merger is approved by the shareholders of each merging company by a vote of over 99 percent after full disclosure of all relevant facts?

2. If such a statutory merger constitutes a "sale" of the securities of the merged company in exchange for securities of the surviving company, is any "profit realized," within the meaning of Section 16(b), by a shareholder company which (i) purchased securities of the merged company on the day of the filing of the merger agreement pursuant to and as a necessary element of the merger plan and (ii) continued to hold such securities beyond the six-month statutory period?

3. Where both the "purchase" and the supposed "sale" held to create liability under Section 16(b) were approved by the CAB as not "unfair" to and having "no adverse effect on" shareholders or others, are the courts precluded from finding a "possibility of unfair use of inside information" in the very same transactions so approved by the CAB?

Statute Involved

The statutory provision involved is Section 16(b) of the Securities Exchange Act of 1934 ("the Exchange Act"), 15 U.S.C. § 78p(b), which relates to insider short-swing "purchases and sales" of securities. The text of Section 16(b) is as follows:

> "(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring

such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.".

STATEMENT OF THE CASE

Introduction

On September 18, 1967, Petitioner RKO General, Inc. ("RKO") invested $7.5 million in securities of Central Airlines, Inc. ("Central") upon condition of a merger of Central into Frontier Airlines, Inc. ("Frontier"), an RKO subsidiary company. On the same day, pursuant to shareholder and Civil Aeronautics Board ("CAB") approval, Central was merged into Frontier. RKO holds the securities resulting from the merger to this day.

Section 16(b) applies to in-and-out insider trading. Here Petitioner RKO got "in"-but never "out."

Section 16(b) applies to "profit realized." Here nothing was realized. The Court below said that by the merger RKO received securities worth in its opinion approximately $8 million more than RKO paid for the securities of Central on that day. It entered a massive judgment of approximately $8 million, by far the largest single cash judgment ever entered under Section 16(b) and perhaps the largest ever under the federal securities laws. Further, by the

time judgment was ordered by the District Court the securities received on the merger (still held by RKO) were worth at market $3.5 million *less* than the purchase price, and today are worth at market $5.3 million *less* than the purchase price.

The lower courts held that a single investment decision to invest in a merged Central-Frontier airline[1] on a permanent basis involved both a "purchase and sale," and that an investment which was not intended to be liquidated, which could not have been lawfully liquidated and which has not in fact been liquidated to this day brought RKO a "realized profit" of $8 million.

The judgment below would require RKO to pay $15.5 million instead of the agreed purchase price of $7.5 million for securities which today have a market value of $2.3 million.

Section 16(b), a simple, sensible absolute liability statute, has been misapplied here. Section 16(b) was intended only to reach speculative in-and-out trading. Here that statute was applied to a long-term, indeed permanent, investment. Section 16(b) was intended only to deprive a speculative trader of the cash or cash equivalent profit realized on his short-swing trade. Here the merger produced no cash or cash equivalent profit; RKO, the parent company, received only securities of the surviving subsidiary, Central-Frontier. A sale by RKO of the Central-Frontier securities received pursuant to the merger would have violated the basic objective of the transaction as well as RKO's covenants to the sellers, to the shareholders, to the CAB and to the Internal Revenue Service. And these securities

[1] The District Court (Tyler, J.) referred to the merged successor corporation as "Central-Frontier." (See Appendix ("App.") B, p. 19a, *infra*.)

have not been sold by RKO. Nevertheless, RKO was ordered to pay an $8 million judgment for "profit realized" on a Section 16(b) "purchase and sale."

The decision, for reasons stated below, is of such major importance, so at variance with the decisions of this Court and other Circuit Courts, and so bound to cause confusion in the law that review and clarification by this Court are imperative.

The Facts

The Parties. RKO General, Inc. is a wholly-owned subsidiary of General Tire & Rubber Company, a publicly-owned company whose shares are traded on the New York Stock Exchange. In early 1967, RKO owned approximately 56 percent of the shares of Frontier Airlines, an airline certificated by the CAB and engaged in scheduled local service air transportation in 11 Rocky Mountain States.[2] The remaining 44 percent of the stock of Frontier Airlines was broadly held by the public (in 1967, Frontier had 5,700 shareholders of record (J.A. 343a)). Frontier's shares are traded on the American Stock Exchange (J.A. 264a, p. 7).

In about March 1966, RKO commenced discussions concerning a merger of Frontier Airlines with Central Airlines, another scheduled local-service airline operating in the contiguous States of Texas, Colorado, Oklahoma, Kansas, Missouri and Arkansas (J.A. 402a; J.A. 264a, p. 29). Central also had a large number of public shareholders (in 1967 there were over 1,600 Central shareholders of record (J.A. 344a)). Central shares were traded in the over-the-counter market (J.A. 264a, p. 7) and Central filed

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[2] Arizona, Colorado, Missouri, Montana, Nebraska, New Mexico, North Dakota, South Dakota, Texas, Utah and Wyoming. Joint Appendix ("J.A.") 264a, p. 24.

annual reports and financial statements with the Securities and Exchange Commission ("SEC").

Approximately 66 percent of the shares of Central were held by six Central insiders—the Chairman of the Central Board of Directors and five other Central directors (J.A. 264a, Exhibit "A," p. 9; J.A. 275a; App. A. p. 5a, n. 3, *infra*).

Frontier was the fifth largest of the thirteen scheduled local-service airlines and Central was the smallest of these (J.A. 264a, pp. 24, 30). Frontier had a stronger financial structure (J.A. 311a, *cf.* 315a). It was hoped that a merged Central-Frontier system would result in more profitable operations (J.A. 319a). It was believed that because the routes of the two airlines were contiguous and in some cases used the same airports, the merged company might obtain through routes, substantial cost savings and increased earnings (J.A. 311a-12a).

Merger Negotiations. Discussions concerning the possibility of a Central-Frontier merger took place during the spring of 1966 (J.A. 402a-03a) and then broke off. In September 1966, Central entered into a merger agreement with Ozark Airlines, which was, however, terminated in November 1966. In late February 1967, negotiations for a Frontier-Central merger were resumed but it was not until May 2-4 that an agreement was reached (J.A. 403a-07a). RKO desired to acquire a controlling interest in Central in order to maintain its majority interest in the merged airline and the Central insiders wanted cash for their shares. Therefore, it was agreed in May 1967 as follows: that there would be a Central-Frontier merger; Frontier would be the surviving company; the exchange ratio would be 3.5 shares of Central for one share of Frontier; and,

upon condition of the conclusion of the merger, RKO would purchase at $8.50 a share a majority of Central securities from the Central insiders (J.A. 238a, 404a-07a).

The merger and stock purchase agreements were signed effective as of May 4 and on that same day public announcement was made of the proposed Central-Frontier merger and RKO's securities purchase (J.A. 250a-51a). The story was carried in the Wall Street Journal the next day (J.A. 398a).[3]

The merger agreement between Central and Frontier provided for a statutory merger of these two Nevada corporations[4] if, *inter alia*, the CAB approved the merger without material adverse conditions and awarded Central-Frontier an acceptable subsidy rate and if certain creditors of Central and Frontier approved (J.A. 264a, Ex. "A").

The purchase agreement between RKO and the Central insiders provided that RKO would buy, and the Central insiders would sell controlling shares in Central for $8.50 per share or an aggregate price of $7,550,082.50.[5] This purchase was expressly conditioned upon a Central-Frontier merger (J.A. 275a).

In the purchase agreement, RKO specifically represented to the selling Central directors that its purchase of Central securities was for investment purposes only, a representa-

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[3] The Central Board of Directors and the Frontier Board of Directors formally approved the merger agreement on May 8 and May 10, respectively (J.A. 408a).

[4] Section 78.495 of the Nevada Revised Statutes provides that a merger becomes effective upon the filing of a merger agreement.

[5] The sale included 49 percent of the common stock of Central and an entire issue of debentures convertible into another 7 percent of Central stock. (See App. C, p. 44a, *infra*.) The price per share was applied to the debentures so that RKO paid $8.50 for each share into which the debentures were convertible.

tion specifically made applicable as well to the Central-Frontier securities to be received upon the merger (J.A. 283a). A similar representation was made to the CAB. In addition, RKO represented to the Internal Revenue Service that it had no present intention to dispose of its investment (J.A. 238a-39a).

Shareholder Approvals. On July 3, after the filing of proxy materials with the SEC and the receipt of the SEC's comments (J.A. 268a), proxy statements requesting approval of the merger were mailed to all 5,700 Frontier shareholders and 1,672 Central shareholders for meetings to be held in Denver and Fort Worth, respectively, on the 27th of July (J.A. 264a, p. 38).[6] The proxy statements, identical except for separate notices of meeting, consisted of 59 printed pages, plus exhibits.

No suggestion has ever been made that the proxy statement was not full, complete and accurate in every respect.

The statement described in detail the principal shareholders of both companies, the merger agreement, the stock purchase agreement, the price range of the stock of the companies, financial information relating to both companies, the regulation of airlines, the business and property of the constituent corporations, and the proposed management of the surviving corporation. Attached also were the text of the merger agreement, the provisions of the Nevada corporation law respecting dissenters, as well as certain amendments to the certificate of incorporation of the surviving corporation (J.A. 264a).

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[6] Respondent Newmark did not receive a proxy statement since she was not a shareholder of either Central or Frontier. She held only Frontier debentures and warrants (App. B, p. 20a, n. 1, *infra*).

On July 27 at the respective meetings of the two corporations, the merger agreement was approved by over 99 percent of the shareholders of both corporations. No dissenters requested to be paid in cash (J.A. 239a).

CAB Approval. RKO was the controlling person in one airline (Frontier) and was forbidden by Section 408 of the Federal Aviation Act, 49 U.S.C. § 1378, to acquire controlling shares in any other airline (Central) without CAB approval. Therefore the RKO stock purchase and the Central-Frontier merger could take place only with CAB approval.

Promptly after the signing of the agreements of May 4, 1967, application was made to the CAB for approval of "the stock purchase and merger contemplated therein" (J.A. 296a, 299a). The CAB gave notice and held a public hearing before a Hearing Examiner. Nine other airlines and four employee unions applied for and were granted permission to intervene (J.A. 305a). No shareholder of Central or Frontier appeared to oppose the merger (J.A. 316a). Hearings were duly held and on August 2, 1967, the Hearing Examiner rendered a detailed Initial Decision approving the stock purchase and merger (J.A. 301a).

The Hearing Examiner's Decision considered the purchase agreement and the merger agreement since, as he stated (J.A. 306a-07a), both required approval by the CAB. He considered the financial condition of both companies, their subsidy situation with the CAB, the possible savings from the merger and the expected net income. He found that "the financial strength of the combined companies will be substantially improved over that of Central at present" (J.A. 311a). He discussed the possibility of through-flights and resulting increased net income (J.A. 311a-12a). He considered the public interest, including the

question "whether the price is reasonable with reference not only to the two carriers but also to the minority stockholders, the public, and the Federal Government" (J.A. 313a). He decided that "after the disruptions from consummating the merger have been overcome, the financial benefit to Frontier will be substantial" (J.A. 313a-14a).

The Hearing Examiner noted that "Central and Frontier have been completely independent organizations and all negotiations have been carried on at arm's length" (J.A. 314a). He considered the market prices and book value at various times of the Central and Frontier stock (J.A. 314a-15a), and determined that the $8.50 price for Central stock was "within the realm of sound business judgment." He concluded:

> "It cannot be found that the terms of sale of the Central stock or the terms of merger are unfair to either carrier, the stockholders of each, the Federal Government, or the general public." (J.A. 316a-17a).

He also considered the economic impact on personnel of the airlines, the question of monopoly and the possible diversion of traffic from other airlines and the question of subsidy and through service. He held that the merger would "in the long run decrease the subsidy burden or lower commercial fares, or both" (J.A. 321a). Immediately, he held, some subsidy savings should result from the merging of operations and directed an investigation to determine a reasonable subsidy (J.A. 320a). He concluded:

> "The merger will have no adverse effect on either Central or Frontier, their minority stockholders, the general public, competing air carriers, or the Federal Government" (*ibid.*).

The Hearing Examiner's Decision was not appealed, and on September 1, 1967 the CAB ordered that Decision to become effective as of that date (J.A. 300a).

The Consummation of the Purchase and Merger. On September 18, 1967, the CAB determined the subsidy to be paid to Central-Frontier (J.A. 335a). And by September 18, waivers of Central's defaults to its banks and consents to the merger from all Central's and Frontier's banks had been received as required under the merger agreement (J.A. 366a-73a).

Accordingly, on September 18, 1967, all conditions having been met, RKO paid the $7.5 million purchase price to the six selling Central directors and physically took possession of the Central certificates. On the same day, the Central-Frontier merger agreement was filed with the Secretary of State of the State of Nevada, thereby effecting the merger, as the District Court (Bonsal, J.) and the Court of Appeals found below (App. C, p. 42a, *infra*; App. A, p. 6a, *infra*).[7]

The Internal Revenue Service subsequently ruled that the merger would be tax exempt and that Central shareholders would sustain no taxable gain or deductible loss as a result of the merger (J.A. 363a).

RKO continued to hold the securities it received pursuant to the merger[8] and made no sales during the six-

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[7] The merger agreement stated that it was to become effective on the 1st of the month after the filing (J.A. 264a, Ex. "A", Sec. 9, p. 4). However, the October 1st date "was set purely for bookkeeping purposes" to allow the accountants to adjust the books as of the end of the month (J.A. 247a). Accordingly, between September 18 and October 1, various procedural matters occurred, including the issuance by the CAB of the Certificate to Central-Frontier for Central routes, and on October 1, 1967, RKO physically exchanged Central stock certificates for equivalent Central-Frontier certificates (See App. C, p. 42a, *infra*).

[8] RKO received 738,251 shares of Central stock which were exchanged for 421,857 shares of Central-Frontier stock. RKO

month period after the purchase (J.A. 425a, Int. 4; J.A. 428a, Int. 15). In fact, RKO holds these securities to this day.[9]

By the time of the trial, these securities, for which RKO paid approximately $7.5 million, had dropped in market value to $4.1 million.[10] Today they are worth approximately $2.3 million.[11]

The Proceedings Below

On December 14, 1967, Respondent Newmark, an owner of Frontier debentures and warrants, filed a complaint in the United States District Court for the Southern District of New York alleging that RKO's purchase of Central securities was a "purchase" and that the merger with Fron-

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also received $500,000 principal face amount of Central convertible debentures, convertible into 149,994 shares of Central common stock prior to the merger, and convertible into 85,714 shares of Central-Frontier common stock from September 18, 1967, the time of the merger. (The original merger agreement provided for the exchange of 3½ shares of Central stock for 1 share of Central-Frontier stock; however, on July 27, 1967, Frontier shareholders ratified a 2 for 1 split in Frontier common stock. The merger exchange ratio was accordingly adjusted to provide for the exchange of 2 shares of Central-Frontier common stock for each 3½ shares of Central common stock.) App. C, pp. 39a-41a, *infra*.

[9] More than one year after the merger, RKO converted some convertible debentures to common stock, which common stock RKO still holds.

[10] The District Court (Bonsal, J.) noted that Frontier stock was selling at the time of trial "at around 8 compared to 26 on September 18, 1967." App. C, p. 50a, *infra*. RKO owns the equivalent of 507,571 shares of Frontier stock. (421,857 shares of Frontier stock plus debentures convertible into 85,714 additional shares of Frontier stock. See n. 8, *supra*.) 507,571 shares at $8 per share is $4,060,568.

[11] On July 15, 1970, Central-Frontier common stock closed on the American Stock Exchange at $4.50 per share. 507,571 shares of Central-Frontier common stock at $4.50 a share is $2,284,069.50.

tier constituted a "sale" by RKO resulting in a "realized" profit within the meaning of Section 16(b) of the Exchange Act (J.A. 7a). Cross-motions for summary judgment were made with respect to liability. And the District Court (Tyler, J.) granted Respondent summary judgment.

As a preliminary matter, Judge Tyler found that Respondent, a holder of Frontier debentures and warrants, could bring a Section 16(b) action on behalf of Central since Central's Section 16(b) claim "now belongs to Central-Frontier as a result of the merger" and that RKO beneficially owned over 10 percent of Central securities at the time of RKO's "purchase" and "sale" thereof (App. B, pp. 20a, 31a, *infra*).[12]

Judge Tyler held that RKO made a Section 16(b) "purchase" of Central securities on September 18, 1967, and a Section 16(b) "sale" of these securities either on that same day or on October 1, 1967.[13]

After trial on the issue of damages, the District Court (Bonsal, J.) concluded that by the September 18, 1967 merger RKO has "sold" its Central securities for Central-Frontier shares worth $15,470,764—a sum 15 percent above the quoted market price for such securities on that day. Since RKO paid $7,550,082 for its Central securities on that day, Judge Bonsal held that RKO "realized" a one-day Section 16(b) "profit" of $7,920,681.58. He noted that

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[12] We believe these rulings to be erroneous and one or both of these issues may require decision on the merits if certiorari is granted.

[13] App. B, pp. 24a and 22a, n. 4, *infra*. Judge Tyler's statement that the purchase price was $8,550,082.50, App. B, p. 22a, *infra*, was apparently a typographical error. See J.A. 55a. The purchase price was $7,550,082.50. See Judge Bonsal's opinion, App. C, p. 41a, n. 1, *infra*, and J.A. 251a-52a.

RKO had owned 56 percent of the stock of Frontier prior to the merger and purchased an equivalent amount of Central securities so as to maintain its majority interest in Central-Frontier. Accordingly, he added to the September 18, 1967 quoted market price of Central-Frontier securities a "premium factor of 15%" for obtaining and maintaining a control position and ordered the entry of a $7,920,681.58 judgment against RKO (App. C, p. 50a, *infra*).

Judge Bonsal refused Respondent's request for interest from September 18, 1967, because "in view of the fact that [Central-Frontier] stock is currently quoted at around 8 compared to 26 on September 18, 1967 . . . the exaction of interest would be inequitable" (*ibid.*).

RKO appealed and on April 30, 1970, the Court of Appeals for the Second Circuit (per Kaufman, J., speaking also for Feinberg, J. and Palmieri, D.J.) affirmed the District Court in all respects. The Circuit Court found that RKO "purchased"[14] and "sold" Central securities on a single day—September 18, 1967—and that this "purchase and sale" "lent itself to the type of speculative abuse which Section 16(b) was designed to prevent" (App. A, pp. 6a, 7a, 16a, *infra*).

The Circuit Court held that the merger would not be a "sale" unless there was "an opportunity for speculative abuse" (App. A, p. 4a, *infra*). Such an opportunity was found by the Circuit Court on the basis of one essential assumption, unexplained in the opinion: that RKO would in some way "realize" real "profit" if RKO merged Central with Frontier on a day when Central stock was selling

[14] The Circuit Court incorrectly states at one point that RKO's purchase price was $8,550,082.50—again $1 million over the actual purchase price (App. A, p. 6a, *infra*). See n. 13, *supra*.

on the market for more than RKO's $8.50 a share purchase price. The Court treated the temporary difference between purchase price and quoted market price on the day of merger as a "speculative gain," App. A, p. 9a, *infra*. Presumably this was on the theory that receipt of Frontier shares as a result of the merger was equivalent to the receipt of cash or cash equivalent which could be immediately liquidated and was exactly like an amount paid to a trader upon completion of an in-and-out purchase and sale. From this assumed cash or cash equivalent realization, it deducted the cost of the purchase and denominated the balance "realized" profit, to be surrendered to Central or rather its successor, Frontier. RKO's petition for rehearing or, alternatively, rehearing en banc, was denied June 2, 1970 (App. D, p. 52a, *infra*).

REASONS FOR GRANTING THE WRIT

I.

IT IS OF GREAT PUBLIC IMPORTANCE FOR THE COURT TO DECIDE WHETHER A STATUTORY MERGER CONSTITUTES A "SALE" OF SECURITIES OF THE MERGED COMPANY AND A "REALIZATION" OF "PROFIT" BY THE SHAREHOLDERS OF THAT COMPANY WITHIN THE MEANING OF SECTION 16(b) OF THE EXCHANGE ACT.

This case involves by far the largest monetary judgment ever entered in a Section 16(b) case, and probably the largest monetary judgment ever entered in any federal securities action.

The court below disposed of a frequently recurring and fundamental federal securities law question which has not

been but should be decided by this Court. The applicability of Section 16(b), a liability without fault statute, to corporate mergers and securities conversions is a question of such consequence and has resulted in so much litigation with results so confusing as to require clarification by this Court.

The ruling below is also in conflict with the rule laid down in this Court's only Section 16(b) holding, and also in conflict with the rulings of at least four other Circuits.

A. Corporate mergers are frequent commercial events, which affect large numbers of officers, directors and other insiders. In 1969, for example, there were 4,550 mergers and acquisitions in this country.[15] Conversions and reclassifications of securities, which present related Section 16(b) questions, are even more common commercial transactions and have figured in a significant number of Section 16(b) cases.[16] Section 16(b) has produced more litigation than any other provision of the federal securities laws with the possible exception of Rule 10b-5 under Section 10(b) of the Exchange Act, 15 U.S.C. §78j(b). It has also produced a large number of professional commentaries and analyses.[17] The applicability of this fundamental securities statute to corporate mergers and conversions of securities,

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[15] Federal Trade Commission, *Current Trends in Merger Activity, 1969*, Statistical Report No. 6, p. 1 (March 1970).

[16] See, *e.g.*, *Heli-Coil Corp.* v. *Webster*, 352 F.2d 156 (3rd Cir. 1965); *Ferraiolo* v. *Newman*, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); *Petteys* v. *Butler*, 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); *Blau* v. *Max Factor & Co.*, 342 F.2d 304 (9th Cir. 1965), *cert. denied*, 382 U.S. 892 (1965); *Roberts* v. *Eaton*, 212 F.2d 82 (2d Cir. 1954), *cert. denied*, 348 U.S. 827 (1954); and *Blau* v. *Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

[17] See Lowenfels, *Section 16(b): A New Trend in Regulating Inside Trading*, 54 Cornell L. Rev. 45, 49-50, n. 20 (1968).

and to insiders involved in such transactions, is clearly a matter of major economic importance.

If the decision below is correct, then ordinary, perfectly proper commercial transactions will be seriously upset. Mergers and related stock purchases planned for simultaneous performance—as here—will have to be spaced artificially at least six months apart at great commercial and economic inconvenience merely to avoid any question of Section 16(b) liability. In many cases this will not be possible and the transactions will have to be abandoned. Such distortions in important commercial transactions affecting thousands of shareholders should not be allowed unless this Court determines them to be the necessary consequence of a Congressional mandate.

B. In *Blau* v. *Lehman*, 368 U.S. 403 (1962), the only Section 16(b) case ever decided by this Court, it was acknowledged that this statute imposes "extraordinary liability," *id.* at 409, and that such liability should not be stretched judicially. The Court in *Lehman* carefully limited the reach of Section 16(b) and stated that any expansion of the statute should come, if at all, from the Congress, *id.* at 412-13. This approach has been adopted by all the Circuits except the one below. However, the analyses of the Circuits are conflicting and the present state of Section 16(b) law is quite confused.

The Sixth, Eighth and Ninth Circuits have held that a conversion of securities is not a "sale" (or "purchase") unless the transaction allows the possibility of speculative abuse of insider information. Each of these Circuits held that the securities conversion in issue was not a "purchase" within the meaning of Section 16(b); therefore the subsequent sale within six months for cash did not raise Section

16(b) liability. *Ferraiolo* v. *Newman*, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); *Petteys* v. *Butler*, 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); and *Blau* v. *Max Factor & Co.*, 342 F.2d 304 (9th Cir. 1965), *cert. denied*, 382 U.S. 892 (1965).

The Third Circuit in *Heli-Coil Corp.* v. *Webster*, 352 F.2d 156 (1965), held that a conversion of convertible debentures into underlying common stock involved a "sale" of the debentures and a "purchase" of the common stock but that no profit was "realized" on such a transaction since the increment in value was merely on paper.

The results in the Second Circuit have been particularly inconsistent on conversion and reorganization cases. *Cf.* the result below with *Roberts* v. *Eaton*, 212 F.2d 82 (2d Cir. 1954), *cert. denied*, 348 U.S. 827 (1954); *Blau* v. *Mission Corp.*, 212 F.2d 77 (2d Cir. 1954), *cert. denied*, 347 U.S. 1016 (1954); and *Blau* v. *Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967). The Second Circuit employs the "pragmatic" test, and decides whether or not the transactions in issue allow an opportunity for speculative abuse. However, the standards by which the Second Circuit determines opportunity for abuse have not been articulated.

Such conflicting and confusing analyses have obscured the clear purpose and discrete reach of Section 16(b). A "simple" statute, 2 Loss, *Securities Regulation* 1043 (2d ed. 1961), has become unreasonably complicated. It is time for this Court to provide guidance to the lower courts.

Section 16(b) is a statute which assumes that if, *e.g.*, a director buys stock for x dollars and sells it within six months for x + y dollars, he has cash in the amount of x + y dollars in hand and it is a simple matter to compel

him to pay the y dollars constituting the profit into the corporate treasury. He has the cash, the amount due is easily calculated, the rule is clear and the possibility of hardship to him is difficult to envision. The same would obviously be true if the director sold not for cash but for a cash equivalent—*e.g.*, readily marketable securities such as 100 share lots of General Motors or Standard Oil of New Jersey.

But all the Circuit Courts (except the one below) have recognized that corporate action such as a merger, stock reclassification or conversion of one security for another, presents a wholly different situation. *E.g.*, in the present case, a parent corporation with one subsidiary airline acquired control of another subsidiary airline and merged the two subsidiaries pursuant to government and shareholder approval. There is a purchase and an outlay of funds but there is no sale and no realization of funds. There is an x but no y. There is no cash or cash equivalent received. The shares received on the merger are control shares intended to be held and required to be held for investment and are not readily disposable. There are no funds on hand to pay any "realized profit" unless and until the investment and the securities received on the merger are liquidated. If liability is imposed, it will require payment from sources unrelated to the transaction, *e.g.*, a borrowing or a sale of other productive assets of the parent company, RKO. And, of course, in many cases there may be no sources from which such a judgment can be met.

Accordingly, in *Ferraiolo, supra*, the Sixth Circuit, dealing with a conversion of preferred for common, refused to find Section 16(b) liability with respect to a transaction which "was not one falling within the ordinary concept of a 'purchase,' [but which] the statutory definition would

not necessarily exclude . . . ." 259 F.2d 342 at 344. In *Heli-Coil, supra,* on similar facts, the Third Circuit found a "purchase" or "sale" but no "profit realized." Thus courts have recognized that such transactions do not truly involve a first time acquisition of a security, or a final disposition, as Section 16(b) contemplated. They have weighed whether the transaction was merely a change in form of the same investment. They have considered whether an exchange of one security for another provided opportunity for abuse of inside information. However, not only has the reasoning in such cases varied; some results are difficult to reconcile with each other. As evidenced by the facts in the present case, determining a "possibility of abuse of inside information" not on the basis of facts of record but on the basis of speculation and abstract theorizing permits arbitrary and unpredictable results.[18]

Clarification of Section 16(b) by this Court is necessary. This Court should say whether transactions of conversion, reclassification, and merger are ever sales and purchases within Section 16(b) and, if they are to be regarded as purchases and sales, whether profit is realized on such transactions. The Court should say whether in construing Section 16(b), courts are forbidden or permitted to speculate without evidence, as the court below did, on the "possibility" of unfair use of information and, if so, what standard is to be applied to prevent arbitrary speculation. This Court should say whether the possibility of unfair use of inside information, if that is an appro-

[18] " . . . the case by case analysis as to 'possibility for speculative abuse' offers scant guidance to possible 16(b) defendants. 'The complexities of the commercial and financial world' that have made automatic liability workable, seem also to make the 'flexible' approach troublesome in its unpredictability." Goodman, *Expanding Short-Swing Liability,* 3 Rev. of Sec. Reg. 891, 896 (1970).

priate standard, requires that there be a "possibility" of injury to other shareholders, or whether, as here, there can be a possibility of "abuse" when no person or group could have been hurt.

Mr. Justice Harlan, for himself and Mr. Justice Stewart, expressed the view in *SEC v. National Securities, Inc.*, 393 U.S. 453, 471, 472 (1969) (concurring in part and dissenting in part) that the definitions of "purchase" and "sale" for purposes of the federal securities laws are "fundamental matters." This is especially so where the statute in question imposes absolute liability without fault. In this "area where glib generalizations and unthinking abstractions are major occupational hazards," (Marshall, J.), *id.* at 465, and where the commercial consequences are so steep, it is of considerable public importance for this Court to decide here whether or not a statutory merger involves a Section 16 (b) "sale" producing "realized" "profit" for the stockholders of the merged company.

Mr. Justice (then Judge) Blackmun, dissenting in *Petteys v. Butler*, 367 F.2d 528, 539 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967), had occasion to note the conflicts among the Circuit Courts with respect to the reach of Section 16(b). He said:

> "Perhaps the Supreme Court one day soon will tell us how these somewhat conflicting approaches to § 16(b) by the Court of Appeals are to be resolved."

We respectfully suggest that such resolution and clarification are called for now. The case at bar squarely presents such an opportunity; it involves a substantial judgment of dubious validity, and questions common to frequent, commercially important transactions.

C. The decision below is inconsistent with the *Lehman* approach to Section 16(b). Here a single transaction, involving an investment in acquiring an extension of an existing airlines business, was artificially split into both a Section 16(b) "purchase" and a Section 16(b) "sale." A theoretical opportunity for speculative abuse was premised upon an unsupported assumption that RKO could "realize" "profit" if the quoted market price for Central stock on the day of the purchase and merger exceeded RKO's purchase price. And a transaction acknowledged by the District Court (Bonsal, J.) to represent in reality a *loss* for RKO sufficient to make it "inequitable" to charge interest (App. C, p. 50a, *infra*)—a $7.5 million purchase worth $4.1 by the time of trial—was somehow converted into a $7.9 million "realized" profit which must be forfeited!

Our position is that a statutory merger of corporate subsidiaries is not a "sale" for purposes of Section 16(b). This Court recently noted that the word "sale"—one of the key words in this case—"may take on different coloration in different sections of the securities laws." *SEC v. National Securities, Inc.*, 393 U.S. 453, 466 (1969). A statutory merger, like the one involved here, is not a "sale" for purposes of registration under Section 5 of the Securities Act of 1933, 15 U.S.C. § 77e; see SEC Rule 133, 17 C.F.R. § 230.133; *cf.* 393 U.S. 453 at 465-66. Nevertheless, in *National Securities*, this Court held that such a merger is a "sale" within the meaning of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), a statute outlawing actual fraud and deceit in connection with the "sale" of securities. 393 U.S. at 467.

There is good reason to interpret Section 10(b) broadly and Section 16(b) more narrowly. Section 10(b) liability is based upon actual fraud and actual insider misuse of

insider information. See, *e.g., SEC* v. *Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part and rev'd in part* 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom. Kline* v. *SEC*, 394 U.S. 976 (1969). Section 16(b) liability is imposed without fault and without any evidence of actual abuse of inside information.

However, even if this Court were of the view that such a merger might involve a "sale" for purposes of Section 16(b) if it allowed an opportunity for speculative abuse, it is incumbent upon this Court to provide clear and realistic guidelines for determining "opportunity for abuse." The lower courts require such guidelines if they are to enforce Section 16(b) consistently and fairly. And businessmen need such guidelines if they are to plan their affairs prudently.

Potential abuse should be found only where some specific injury to some specific affected group—the selling shareholders, or the other shareholders of the merging corporations, for example—might be possible. If courts are to impose absolute liability without fault because of a possibility for abuse, at minimum that possibility should be one of specific harm to a specific affected group. Here there was no such possibility. Indeed, there was no use of inside information. The purchase and merger agreements were announced immediately after they were made and the merger was approved after full disclosure to all the shareholders in a complete and accurate proxy statement. (See *infra*, pp. 33-35.)

Here, in the words of Mr. Justice (then Judge) Stewart in *Ferraiolo* v. *Newman*, 259 F.2d 342, 346 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959): "All of the . . . shareholders were treated alike; full disclosure was made to them; the conversion worked no material change in [their]

proportional equity ownership . . . ." In *Roberts* v. *Eaton*, 212 F.2d 82, at 85 (2d Cir. 1954), *cert. denied*, 348 U.S. 827 (1954), Judge Clark, joined by Mr. Justice (then Judge) Harlan, noted that "like treatment of all stockholders will in most cases remove the possibility of abuse."

The Court below ignored such factors in determining "opportunity for speculative abuse," for purposes of Section 16(b).

The soundness of the *Lehman* interpretation of Section 16(b), as a provision not to be extended because of its liability without fault aspect, is further confirmed by the courts' effective and flexible use of Section 10(b) and Rule 10b-5 in cases of *actual* unfair use of inside information. See, *e.g.*, *SEC* v. *Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part and rev'd in part*, 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom. Kline* v. *SEC*, 394 U.S. 976 (1969).[19]

This situation urgently requires clarification by this Court.

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[19] We cite the words of a recent commentator:

> "There is no longer any reason for the federal courts to be harsh and objective in interpreting and applying section 16(b). Everything that this section was designed to accomplish, and much more, is presently being accomplished under section 10(b) and rule 10b-5."

Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading*, 54 Cornell L. Rev. 45, 63 (1968). (Footnotes omitted.) Another commentator has observed: "*Newmark* appears to be evidence that the 'statutory purpose' approach, originally a protection for defendants, can lead to the application of Section 16(b) to situations unrelated to the statutory purpose—and better handled under the antifraud provisions of the Exchange Act." Goodman, *Expanding Short-Swing Liability*, 3 Rev. of Sec. Reg. 891, 896 (1970).

II. THE QUESTIONS PRESENTED ARE SUBSTANTIAL.

Liability was found below by disintegrating a single investment transaction which allowed for no unfair use of inside information. This transaction surely constituted a "purchase," but it did not constitute a "purchase *and sale*," or produce a "realized profit," within the meaning of Section 16(b).

A. Section 16(b) applies when profit is realized upon an in-and-out "purchase and sale".

Section 16(b) was intended to take the profit out of in-and-out short-swing trading by corporate insiders. As Thomas G. Corcoran, one of the draftsmen of the Exchange Act, testified, this section was intended to apply to an insider who "bought *to get out on the short swing*."[20] Section 16(b) is with us because "Improper use of inside information by corporate insiders is most likely to occur in short-term, *in-and-out* trading. The temptation to trade upon inside information is enhanced when the period for which capital must be committed is short." *Blau* v. *Max Factor & Co.*, 342 F.2d 304, 308 (9th Cir. 1965), *cert. denied*, 382 U.S. 892 (1965). (Emphasis supplied.) Spectacular examples of such in-and-out trading were before the Congress which enacted Section 16(b). The Senate Report on the Exchange Act[21] noted that Section 16(b)

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[20] Hearings on S. Res. 84 and S. Res. 56 and S. Res. 97, before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6557 (1934). (Emphasis supplied.)

[21] S. Rep. No. 792, 73d Cong., 2d Sess., p. 9 (1934); see also *Blau* v. *Lamb*, 363 F.2d 507, 514-15 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

> ". . . will render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information regarding an increase or resumption of dividends in some cases, and the passing of dividends in others."

In the words of the SEC, "the essential type of transaction intended to be discouraged was the making of purchases with the intention to make a quick sale and the making of sales with the intention of quick repurchase."[22]

Thus Section 16(b) was intended to deprive an insider of the cash or cash equivalent profit reaped—perhaps unfairly—on a short-swing "purchase and sale." Here there was no short-swing "purchase and sale;" there was no opportunity for unfair treatment of anyone; and there was no "realized profit" in cash or cash equivalent.

Any Section 16(b) judgment against RKO would have to be satisfied from sources unrelated to the transaction since RKO obtained no money or money equivalent in connection with the transaction in issue. (See *supra*, pp. 12-13.)

B. The speculative abuse theory of the Court of Appeals mistook a corporate merger for a cash sale. Notwithstanding a purchase at arm's length from knowledgeable Central insiders, notwithstanding full disclosure to and approval by all concerned shareholders and the CAB, and notwithstanding equal treatment of all such shareholders, the Court of Appeals concluded that the transaction raised possibilities for "the type of speculative abuse which Section

[22] SEC Exchange Act Release No. 4509, October 30, 1960, CCH Fed. Sec. L. Rep. ¶ 76,080, p. 78,757 ('48-'52 Decisions).

16(b) was designed to prevent." (App. A, p. 7a, *infra*.) This conclusion depends upon a single assumption: that the transformation of RKO's Central securities into Central-Frontier securities upon the filing of the Central-Frontier merger agreement was equivalent to the receipt by RKO of cash or cash equivalent. This assumption begs the basic question much mooted in the cases cited above of when and to what extent stock converted pursuant to a corporate merger should be regarded as cash or cash equivalent.

From this assumption of cash equivalence, the Circuit Court inferred two opportunities for speculative abuse.

First, the Court stated that RKO might be tempted to schedule the filing of the merger agreement at a time when the quoted market price for Central stock was high and well above RKO's $8.50 purchase price, since the higher the price at the time of the filing of the merger, the higher the profit thereby "realized" by RKO. Second, and conversely, the Court stated that RKO might be tempted to back out of the merger (by taking the position that conditions precedent had not been fulfilled to its satisfaction) if the market price for Central stock dropped below the $8.50 purchase price, thereby avoiding any loss.[23] (App. A, pp. 8a-9a, *infra*.)

These conclusions might follow if the receipt of Central-Frontier securities upon the merger was in fact comparable to the receipt of cash or cash equivalent. But so to hold is to ignore the essence of the transaction. The merger marked the commencement of RKO's interest in Central Airlines, not the realization of any speculative profit on

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[23] Of course, if RKO had backed out of the transaction, there could have been neither a Section 16(b) "purchase" nor a Section 16(b) "sale" nor any "profit realized."

any one-day purchase and sale of that interest. By no reasonable theory can it be suggested that the possibility, probability or certainty of an increase in market value over the $8.50 purchase price, which might occur between May 4 and the filing of the merger agreement, could have induced RKO to enter into this transaction. RKO, Central and Frontier were obliged to enter into major agreements, complete elaborate SEC proxy procedures, convene special shareholder meetings, undertake extensive CAB approval and subsidy proceedings and obtain an Internal Revenue Service ruling. RKO represented to the selling shareholders, to the CAB, to the IRS and to the SEC that the purchase was for permanent investment and not for resale. (J.A. 283a; J.A. 299a; J.A. 346a.) It was clear that, if RKO desired in fact to dispose of Central or Central-Frontier securities for cash, it could not have done so without violation of its covenants to the sellers, the shareholders and the governmental agencies.

RKO was essentially purchasing Central-Frontier securities, which RKO intended to hold and which RKO has in fact held for long-term investment. RKO's unquestioned purpose was to purchase the securities necessary to maintain its majority position in Central-Frontier (*supra*, p. 7). Every objective of the merger would have been defeated by a disposition of the purchased shares.

It thus could not make the slightest difference to RKO whether, at the particular moment of the merger, Central shares were selling on the market for RKO's purchase price, or a lower price or a higher price. RKO could not derive any advantage from a higher market price unless and until RKO actually sold the Central-Frontier securities obtained pursuant to the merger. And RKO did not sell, either during the six-month statutory period or thereafter.

Indeed, even the Court below did not question RKO's intention to hold and not to sell. It affirmed an additional amount in the judgment for a "control premium," for the additional benefit it believed RKO derived from keeping the shares. It compared the merger for this purpose with "previous *purchases* of large quantities of Frontier shares" (App. A, p. 17a, *infra*. Emphasis supplied).

We submit it is not permissible for a court to theorize a possibility of speculative abuse when, as here, the facts belie any such possibility.

Section 16(b) is limited to a particular category of insider security transactions. Section 16(b) liability arises only when (1) there is a short-swing "purchase and sale" by a corporate insider,[24] (2) who could unfairly use insider information for speculative purposes, and (3) "profit" is "realized" on such transactions. Not one of these three essential elements of Section 16(b) liability is present in this case.

C. RKO made a "purchase" but no "sale."

When the Central acquisition and merger took place on September 18, 1967, RKO unquestionably made a "purchase"—essentially a purchase of Central-Frontier securities. Only by separating the inseparable could the courts below conclude that RKO made a "sale" on the same date through the same integrated transaction.

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[24] RKO was neither a Central officer nor director nor owner of Central securities at the time of its purchase of Central securities. It was an outsider dealing at arm's length with the Central insiders. Section 16(b) applies only to beneficial owners who were "such both at the time of the purchase and sale. . . ." We believe that RKO was not an insider at the time of purchase and that the ruling below was erroneous in this respect. It will nevertheless be assumed *arguendo* that RKO was such a Central insider.

The Central acquisition, through stock purchase and merger, was a single business deal. The merger and stock purchase agreements were dependent upon one another for performance; they were simultaneously negotiated, simultaneously approved by the CAB, and simultaneously performed. The Second Circuit acknowledged that,

> "RKO would have violated the CAB's order had it purchased the Central securities, backed out of the merger, and disposed of the securities in return for cash. Under the terms of the [CAB] order, RKO was required to exchange the Central securities it purchased for [Central-Frontier] securities pursuant to the merger agreement." (App. A, p. 12a, n. 5, *infra*.)

Essentially there was but one transaction. It was immaterial as a practical matter whether the merger took place before the stock purchase or vice versa. In either case, the ultimate result was the same: RKO was purchasing Central-Frontier securities. From the moment of purchase, RKO was obliged to perform the merger and receive Central-Frontier securities. Yet the Court below said, in effect, that it made an $8 million difference whether the merger agreement was filed before or after the stock purchase.[25]

In *Blau* v. *Max Factor & Co.*, 342 F.2d 304 (9th Cir. 1965), *cert. denied*, 382 U.S. 892 (1965), one class of stock was converted into another class of stock and then sold for cash within six months of the conversion. The Ninth Circuit found no Section 16(b) liability, because "only one investment decision [had been made] in the six months' period—the decision to [sell]. The exchange was in reality only a

[25] In fact, the record does not reveal the sequence of events on September 18, 1961. It has been assumed, correctly we are informed, that the stock purchase took place a few hours before the merger agreement was filed.

step in the process of sale. . . ." *Id.* at 308. Similarly, only "one investment decision" was made here within six months of September 18, 1967: the decision by RKO to purchase some Central-Frontier securities in connection with a Central-Frontier merger. The two interrelated actions taken on September 18, 1967 were "in reality only . . . step[s] in the process" of purchase.

D. RKO could not have used inside information for speculative profit.

The transaction in issue here, even if improperly split into a "purchase and sale," allowed no actual or potential opportunity for the unfair speculative use of insider information.

1. *There was no actual unfair use of inside information.* The Initial Decision of the CAB Hearing Examiner, which was subsequently made effective by the CAB (J.A. 300a), specifically addressed itself to the effect of the transaction in issue upon Central shareholders and others. The CAB found the merger and stock purchase to be eminently proper and to presage no potential adverse effect upon anyone. After full hearing, that Decision concluded:

> "It cannot be found that the terms of sale of the Central stock or the terms of merger are unfair to either carrier, to the stockholders of each, the Federal Government, or the general public. (J.A. 317a.)
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> * * * * *
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> "The merger will have no adverse effect upon either Central or Frontier, their minority stockholders, the general public, competing air carriers, or the Federal Government." (*Id.* at 320a.)

The CAB found RKO's $7.5 million purchase price to be "within the realm of sound business judgment" (J.A. 316a-17a). (It is questionable whether the CAB would have found it equally sound for RKO to be charged an additional $7.9 million—the amount of the judgment below—for the same securities.) CAB approval of the Central-Frontier merger and the RKO stock purchase establishes that these acts allowed no actual unfair advantage to any of the parties involved.

2. *There was no potential for unfair use of inside information.* The Second Circuit stated "That RKO's heart may have been pure and its motivation noble matters not. The significant factor is whether RKO *could have* reaped a speculative profit from the 'unfair use of information . . . obtained . . . by reason of [its] relationship to [Central].'" (App. A, p. 7a, *infra;* emphasis in the original.) It is essential, however, in determining *potential* unfair use of insider information to determine:

To whom would the use of such information be unfair?

Where no person or group could possibly be hurt by the hypothetical use of inside information posited, there can be no potential abuse within the meaning of Section 16(b). Hence, even assuming that the purchase transaction in issue here were a "purchase and sale," Section 16(b) liability could properly be imposed only if some person or group could have been injured or disadvantaged thereby. Here there was no such person or group.

a. *The selling Central insiders could not have been abused.* The abuses which caused Congress to enact Section 16(b) were those perpetrated by insiders upon others. Insiders would typically buy stock upon inside knowledge of favorable developments to come and then sell when that

knowledge became publicly known and the price of the stock had consequently increased. The unfairness in such a transaction was unfairness to the innocent seller.

Here there was no possibility for RKO to take unfair advantage of those selling to it. The sellers were Central insiders—principal shareholders and directors of Central—who were, of course, no less informed than RKO concerning the proposed Central-Frontier merger.[26] Obviously, these sellers with full knowledge found RKO's purchase price of $8.50 to be fair to them.[27]

b. *The minority shareholders of Central could not have been abused.* In determining whether there was any possibility of abuse of other Central shareholders, it is important to consider whether there was full disclosure to them of the transaction in issue. It is also important to determine whether all Central shareholders were treated equally in the transaction in issue. *Petteys* v. *Butler*, 367 F.2d 528, 537 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); and *Ferraiolo* v. *Newman*, 259 F.2d 342, 346 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

Here the merger and stock purchase agreements were promptly disclosed to the public and thoroughly described again in a lengthy proxy statement delivered to all Central and Frontier shareholders (J.A. 264a). The proxy statement explicitly stated that the stock purchase agreement was "subject . . . to the approval of the proposed

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[26] *Cf.* J.A. 288a with J.A. 264a, Ex. "A", p. 9.

[27] RKO paid $8.50 a share for Central stock which, on May 4, 1967, was selling at around $11.25 a share. J.A. 393a. However, during the first quarter of 1967, Central stock fluctuated between a low bid price of $7.25 and a high asked price of $11. *Id.* at 390a-92a.

merger between Frontier and Central by their respective stockholders" (J.A. 264a, p. 3).

On the basis of such complete disclosure, over 99% of the shareholders of Central and Frontier approved the merger. There is no suggestion that such shareholder approval was not based upon complete and accurate disclosure. The affected stockholders thus expressly and overwhelmingly approved the proposed merger with full knowledge that RKO's $7.5 million securities purchase was an integral part of the transaction.

Moreover, all affected shareholders were treated alike in the Central-Frontier merger. All Central shareholders exchanged Central for Central-Frontier stock pursuant to the same exchange ratio. The District Court (Tyler, J.) found that all Central shareholders "may have benefitted" from an increase in the market value of their shares because of the merger. (App. B, p. 32a, *infra*.) It would be more accurate to say that all Central shareholders but RKO could have been "benefited." The Central-Frontier merger was a boon to all Central shareholders who desired to sell their Central or Central-Frontier shares at the temporarily higher market prices which the Court below attributed to the merger. RKO alone was not free to sell and take advantage of these temporarily higher prices (see *supra*, pp. 8-9).[28]

[28] The Second Circuit did not indicate if or how the stock purchase and merger could have been unfair to minority Central shareholders. But the District Court (Tyler, J.) did note that minority Central shareholders were not afforded RKO's opportunity to purchase Central stock at $8.50 a share (App. B, p. 32a, *infra*). It is, we believe, unprecedented to suggest that one could take unfair advantage of minority shareholders by buying stock from controlling shareholders at a price below market. Whether a purchase from controlling shareholders at a premium price above market, constitutes abuse of minority shareholders is a

E. RKO never realized any profit.

On September 18, 1967, immediately prior to the filing of the merger agreement, RKO owned 56 percent of the common stock of Frontier and approximately 53 percent of the common stock (including shares to be issued upon conversion of convertible debentures) of Central. Upon the filing of the merger agreement, these securities were automatically converted to equivalent Central-Frontier securities. RKO received nothing else in connection with the merger.

RKO's Central-Frontier securities were "the economic equivalent," *Ferraiolo* v. *Newman*, 259 F.2d 342, 345 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959), of RKO's Central securities and RKO's Frontier securities. The whole was precisely the sum of the existing parts.

The Second Circuit acknowledged that the merger was inseparable from the purchase: if the purchase took place the merger had to follow (App. A, pp. 11a-12a, n. 5, *infra*). Thus from the moment of the purchase, RKO was essentially the owner of Central-Frontier securities.

Why Central shares which, by law and CAB order, were required immediately to be converted into Central-Frontier shares by merger were not economically equivalent to the Central-Frontier shares immediately received on the merger was not explained by the Court of Appeals. The Court did not question the real equivalence—indeed, identity—of the Central shares purchased and the Central-

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question much mooted in the courts. But where, as here, the purchase price was $8.50 and the market price was around $11.25 on May 4, 1967 (J.A. 393a), any minority shareholders who wished to sell at that time would have done better on the market.

Frontier shares into which they were converted by operation of law on the same day; rather, the Court stated that such equivalence must be disregarded in the case where two corporations are involved rather than different securities of the same corporation. (App. A, p. 11a, *infra*.) This cannot be a satisfactory answer under a statute which concerns economic realities, *i.e.*, profit realized and possible use of inside information. For Section 16(b) purposes, a theoretical distinction between corporate entities cannot prevail over the facts of real economic equivalence.

RKO received and has held its Central-Frontier securities since September 18, 1967. In the words of the Third Circuit in *Heli-Coil Corp.* v. *Webster*, 352 F.2d 156, 167 (3d Cir. 1965), whatever profits existed on September 18, 1967, by virtue of the increased market price for Central-Frontier securities on that day "were 'paper' profits held . . . at the risk of the market and which could disappear if the market declined to a sufficient extent." In fact, the "'paper' profits" of September 18, 1967 have more than evaporated. RKO's Central-Frontier securities which were purchased for approximately $7.5 million, which had a quoted market price of approximately $13.3 million on September 18, had a quoted market price of approximately $4.1 million by the time of trial below and have a present quoted market price of approximately $2.3 million (*supra*, p. 13). This "loss" was recognized by the District Court (Bonsal, J.), who concluded that the imposition of interest on "profit realized" here would be "inequitable." (App. C, p. 50a, *infra*.)

RKO surely did not "realize" any profit in any realistic financial sense. The differential between RKO's purchase price and market price which obtained on September 18,

1967 could not have been treated by RKO as income or earning or profits.[29]

The IRS confirmed that the conversion of Central securities into Central-Frontier securities, pursuant to the merger, did not result in taxable gain or deductible loss to RKO or other Central shareholders (J.A. 363a).

We submit that no profit was "realized" for Section 16(b) purposes when Central securities were converted to Central-Frontier securities by reason of the Central-Frontier merger.

F. The courts are precluded from finding Section 16(b) liability because the purchase and supposed "sale" were approved by the CAB.

As previously noted (*supra*, pp. 10-12), the Central-Frontier merger and RKO stock purchase were approved by the CAB upon a full record and formal hearing. The CAB determined that the terms of the merger and stock purchase were not "unfair" to the shareholders or to any other affected person and that the merger "will have no adverse effect" upon the shareholders or others (J.A. 317a, 320a). No judicial review was sought from the CAB Decision and Order.

In these circumstances, it is our position that Section 414 of the Federal Aviation Act, 49 U.S.C. § 1384,[30] fore-

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[29] "While it may be entirely appropriate to use the increase or decrease in net asset value between two periods as a standard for the company's progress on a market value basis, it is misleading to label the increase in net asset value as 'earnings' or 'profits.' *The concept of 'profits' does not include an appreciation in market value that is not realized. Free Traders, Inc.*, 7 SEC 926 (1940)." Rappaport, *SEC Accounting Practice and Procedure* 16.20 (2d ed. 1963). (Emphasis supplied.)

[30] This section provides that "Any person affected by any order made under [the merger and related provisions] of this title shall

closes any court from imposing Section 16(b) liability because of any theoretical possibility of unfair use of inside information. Such a theory of liability was expressly rebutted by the CAB's findings.

At minimum, these findings by the CAB are not susceptible to collateral attack, such as in the present proceedings. However, even assuming that the CAB's findings could be challenged in such collateral fashion, there is no basis for overruling them here.

Even on direct judicial review of an administrative agency decision, the review of a factual finding "is limited to consideration of whether it has a rational basis and is supported by substantial evidence." *Gilbertville Trucking Co. v. United States*, 371 U.S. 115, 126 (1962). In the Central-Frontier merger proceedings before the CAB, there was substantial evidence to support the CAB finding; the lower courts made no finding to the contrary.

But even assuming that Respondent were free to challenge the CAB findings *de novo* in the District Court proceedings, Respondent absolutely failed to do so. She introduced no evidence on the question of fairness or opportunity for abuse. Indeed, the CAB findings are the only evidence in the record before this Court.

In the face of the CAB Decision and Order, Section 16(b) liability cannot properly be imposed here.

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be, and is hereby, relieved from the operations of the 'antitrust laws', . . . and of all other restraints or prohibitions made by, or imposed under, authority of law, insofar as may be necessary to enable such person to do anything authorized, approved, or required by such order."

CONCLUSION

For these reasons, a Writ of Certiorari should issue to review the judgment and opinion of the Second Circuit.

Respectfully submitted,

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July 31, 1970

APPENDICES

APPENDIX A

Opinion of the Court of Appeals, Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 612—September Term, 1969.

(Argued April 2, 1970 Decided April 30, 1970.)

Docket No. 34345

MARGOT NEWMARK,

Appellee,

—v.—

RKO GENERAL, INC.,

Appellant,

and

FRONTIER AIRLINES, INC.,

Defendant.

Before:

KAUFMAN and FEINBERG, *Circuit Judges,* and PALMIERI, *District Judge.**

Appeal from an order of the United States District Court for the Southern District of New York, Harold R. Tyler, *Judge,* granting plaintiff-appellee's cross-motion for summary judgment on the issue of liability and from a judg-

* Of the Southern District of New York, sitting by designation.

ment entered in the United States District Court for the Southern District of New York, Dudley D. Bonsal, *Judge*, sitting without a jury, awarding damages in the amount of $7,920,681 under section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b). Affirmed.

MARVIN SCHWARTZ, New York, N. Y. (David L. McLean, Sullivan & Cromwell, and Regan Goldfarb Powell & Quinn, New York, N. Y., on the brief), *for appellant*.

STANLEY L. KAUFMAN, New York, N. Y. (Shephard S. Miller, Allan K. Peckel, and Kaufman, Taylor, Kimmel & Miller, New York, N. Y., on the brief), *for appellee*.

KAUFMAN, *Circuit Judge*:

Section 16(b) of the Securities Exchange Act of 1934 is one of several provisions of the federal securities laws designed to deter insiders from trading on the basis of information unavailable to the general public.[1] Commonly

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[1] The statute reads:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the

termed "a crude rule of thumb," the statute seeks to prevent insiders from realizing profits on securities held for short periods of time.[2] It is not aimed solely at the actuality of evil, or the veritable employment of inside information for purely speculative purposes, but also at potentiality for evil inherent in all insider short-swing trading.

To maximize its deterrent effect, the section is drafted in clear, straightforward terms. It provides that whenever a director, officer or owner of ten percent or more of any class of an issuer's securities purchases and sells equity securities of that issuer within a six-month period, he must return any profits he realizes to the issuer. There are no other prerequisites or postulates to liability. The purpose and reach of the statute, it was thought, would be clear, and litigation seldom necessary.

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issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This section shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

[2] The description, "a crude rule of thumb," was first employed by Mr. Thomas Corcoran, spokesman for the drafters of the statute, during congressional hearings on the bill which ultimately became section 16(b). Hearings Before Senate Committee on Banking & Currency, 73d Cong., 2d Sess. 6557 (1934). The phrase now serves to describe not only the statute but also one approach to its application. Under the "objective" or "rule of thumb" approach, the statute is applied to all transactions which seem to fall within its terms, without regard to whether imposition of liability would further the purposes of the statute. See, e.g., *Heli-Coil Corp.* v. *Webster*, 352 F.2d 156 (3d Cir. 1965). We have rejected this interpretation, see *Blau* v. *Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967), in favor of the more "pragmatic" approach of applying the statute only to those situations subject to speculative manipulation. For a comparative analysis

The complexities of the commercial and financial world, however, have defied the draftsmen's efforts at neat classification. Whether certain "unorthodox" transactions, well illustrated here by the exchanges of securities incident to a merger which form the basis of this appeal, are "purchases" or "sales" for the purposes of section 16(b) cannot be resolved by mere reference to the words of the statute. In such cases, the determination of the statute's relevance must rest, initially, on whether there exists the potential for evil against which the statute was intended to guard. *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967). Only when an opportunity for speculative abuse is present is it necessary to determine whether the transactions alleged to give rise to 16(b) liability may fairly be characterized as insider purchases and sales.

I. Facts

The facts are undisputed. In April 1967, the managements of Frontier Airlines, Inc. and Central Airlines, Inc. reached a provisional agreement to merge their companies by an exchange of stock. Defendant RKO controlled Frontier at that time through its ownership of 56% of the company's outstanding common stock. On May 3 or 4, 1967, RKO contracted with several major Central shareholders to purchase, at $8.50 per share, 738,251 shares of Central common (representing 49% of Central's outstanding shares), and $500,000 of Central debentures convertible into an additional 149,994 shares. The parties do not dispute that these debentures were "equity" securities. The formal merger agreement, providing for the exchange of

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of the two approaches to application of the statute, which concludes that this Circuit's rule is preferable, see Note, *Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale"?*, 117 U. Pa. L. Rev. 1035 (1969).

3½ shares of Central common for each share of Frontier common, was executed on May 4. The first disclosure of the agreements to the public and minority shareholders of both corporations occurred the following day.

Shareholder approval of the proposed merger was foreordained, for the terms of the purchase contract obliged the majority shareholders of both corporations to vote their shares in favor of the proposal.[3] The Central shareholders were also required to manage their corporation in a manner which would not prejudice RKO. Since two airlines were involved, consummation of the merger was conditioned on approval by the CAB. The task of processing the merger through the CAB apparently fell upon RKO; accordingly, its subsidiary Frontier was afforded full access to the books and records of Central. If, in RKO's "good faith judgment," the subsidy awarded the surviving corporation by the CAB was inadequate, or any of the other conditions imposed by the CAB adversely affected the interests of any of the parties, the contract granted RKO the right to abandon the agreements. An additional provision conditioned the merger on the consent of certain Central creditors and their waiver of Central's loan defaults.

As anticipated, the majority shareholders of the two companies voted their endorsement on July 27. On the same day, the Frontier shareholders authorized a two-for-one stock split. The exchange rate in the merger agreement was accordingly adjusted to 3½ Central shares for each two

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[3] Paragraph 2(b) of the purchase contract required the sellers, owners of 66% of Central's voting shares, to cause "Central to take all necessary corporate action to approve and authorize the merger with Frontier (including the approval thereof by Central's stockholders)"; similarly, paragraph 5(c) required RKO, owner of 56% of Frontier's voting shares, to cause "Frontier to take all necessary corporate action to approve and authorize the merger with Central . . . including voting the stock of Frontier owned by RKO in favor of such merger."

shares of Frontier. Less than a week later, on August 2, the CAB added its imprimatur by approving RKO's purchase of the Central stock and the merger agreement. After Frontier, the surviving corporation, signified its satisfaction with the amount of the subsidy to the new airline and the other conditions imposed upon the merger by the CAB, the CAB's order of approval became final on September 1. During the ensuing weeks, Central's creditors, seemingly as a matter of course, agreed to waive Central's loan defaults.

On September 18, the purchase agreement was executed; RKO paid the contract price of $8,550,082.50 and received in return the Central shares and debentures. That same day the parties filed the merger agreement with the Secretary of State of Nevada, the state of incorporation of both Frontier and Central. The physical exchange of Central certificates for Frontier certificates, at the rate embodied in the merger agreement, occurred on October 1.

Plaintiff Newmark, an owner of Frontier debentures and warrants since April 1967, instituted this action in the Southern District of New York in December 1967.[4] After

[4] On this appeal, RKO raises for the first time a belated challenge to the plaintiff's standing to maintain this action. The statute authorizes "the owner of any security of the issuer," in this case Central, to institute an action on behalf of the issuer. Relying on a literal reading of the statute, RKO argues that plaintiff's ownership of Frontier securities is irrelevant and that since she never owned Central shares she does not have standing to bring this action. This argument is without merit. Central no longer exists. Any cause of action it may have had now belongs to Frontier, the company into which it merged. Any recovery will redound to Frontier's benefit. Those most interested in securing this recovery are the holders of Frontier's securities, and they are the proper parties to bring an action for its benefit. *Blau v. Oppenheim*, 250 F. Supp. 881 (S.D.N.Y. 1966). Moreover, RKO did not raise Newmark's alleged lack of capacity to sue in the district court; its present attempt to raise this defense for the first time would appear untimely. Fed. R. Civ. P. 9(a), 12(b); C. Wright, Federal Courts 280 (2d ed. 1970).

both parties moved for summary judgment on the undisputed facts we have recited, Judge Tyler granted Newmark's cross-motion for summary judgment on the issue of liability. A trial on the issue of damages followed; at its conclusion Judge Bonsal awarded damages in the amount of $7,920,681. The award was based upon the difference between the purchase price of the Central shares and debentures and the market price of their equivalent in Frontier shares on the date of the merger, to which sum Judge Bonsal added a control premium of 15%.

II. Potential for Speculative Abuse

The threshold issue raised on this appeal is whether the purchase and subsequent exchange of Central shares lent itself to the type of speculative abuse which section 16(b) was designed to prevent. *Blau v. Lehman*, 286 F.2d 786 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962); *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947). That RKO's heart may have been pure and its motivation noble matters not. The significant factor is whether RKO *could have* reaped a speculative profit from the "unfair use of information . . . obtained . . . by reason of [its] relationship to [Central]." Securities Exchange Act of 1934, §16(b), 15 U.S.C. §78p(b).

RKO's contract to purchase Central shares is a classic example of trading while in the possession of information unavailable to the general public. On May 3 or 4, 1967, RKO secured a contractual right, conditioned on CAB approval of a related merger, to purchase Central common shares for $8.50 per share. Because of its control of Frontier and consequent involvement in the merger negotiations between Frontier and Central, RKO had full knowledge of the proposed merger at the time it signed this contract. Release thereafter of the proposed merger agreement to

the public caused a predictable rise in the price of the securities of both airlines. RKO was in an ideal position to take speculative advantage of this rise by purchasing Central securities at a price established in the purchase agreement before public disclosure of the proposed merger and disposing of these securities after disclosure had caused them to increase in value.

In an effort to establish the absence of an opportunity for speculative manipulation, RKO emphasizes the connection between the prices of Frontier and Central shares during the period subsequent to the release of the merger agreement to the public. It argues that whatever the absolute price of Frontier common may have been at various times during this period, it tended to remain approximately 3½ times greater than the price of Central common, the ratio set forth in the merger agreement. Thus, RKO says, it was impossible to profit from an exchange of Central shares for Frontier shares. This argument would have some merit if RKO had possessed no more than an option to purchase a quantity of Central shares at an unspecified price, but on the facts before us, it is no more than a red herring: RKO possessed an option to purchase, not at the market price on the day of purchase, but at the fixed price of $8.50 per share. Accordingly, the constant ratio between the prices of Central shares and Frontier shares did not preclude the realization of speculative profits; rather, the fluctuating ratio between the prices of the shares of both companies and the previously established purchase price of $8.50 per share made these gains possible.

Moreover, the potential for speculative abuse did not end with the fixing of the purchase price for Central shares prior to the release of the news of the proposed merger to the public. Under the terms of the merger and purchase agreements, RKO secured several advantages. It not only

acquired knowledge of what would transpire but also could exercise substantial influence over the course of events. Once the CAB had granted its initial approval on August 2, RKO had the power to determine when or, for that matter, if the purchase and merger would take place. RKO had no obligation to purchase the Central shares unless, in its "good faith judgment," the subsidy granted the merged airline by the CAB was satisfactory. It was thus in a position to maximize its speculative gain in Central shares by withholding its expression of satisfaction with the subsidy until the rise in the price of both Central and Frontier shares fully reflected the impending merger. At the same time, it should be clear that RKO's power to reject the subsidy would have enabled it to escape any possible loss in Central securities. If, for some unexpected reason, the contemplated rise in the price of Central and Frontier shares had not followed the public announcement of the proposed merger, RKO could easily have avoided the entire transaction without incurring any legal liability. The purchase and merger agreements placed RKO in a position which must be the dream of every speculator—"Heads I win, tails I do not lose."

In sum, the purchase and subsequent exchange of Central shares were fraught with opportunities for the kind of speculative abuse section 16(b) was intended to abort. RKO's success in fixing the purchase price before the proposed merger became public knowledge opened the door to possible speculative gains. Its ability to determine whether and when the merger would be consummated enabled it to maximize these gains or, at the very least, to avoid any loss.

III. Statutory Requirements

Having disposed of the threshold question and determined that the purchase and exchange of Central shares

presented opportunities for the type of speculative evil against which section 16(b) was intended to guard, we must now decide whether RKO's transactions in Central common stock fall within the scope of the statutory provisions. Before liability can attach under 16(b) there must be (1) a purchase and (2) a sale of securities (3) by one who owns more than 10 percent of any one class of the issuer's securities (4) within a six-month period.

A. *Purchase and Holding Period*

As to two of the four elements, there can be little dispute. Since all of the events relevant to this appeal transpired within a six-month span during the year 1967, any purchase and sale which formed a part of these events occurred within the statutory period. Similarly, by any rational definition, RKO's exchange of $7,550,082.50 in cash for Central's common stock and convertible debentures was a "purchase" of those securities.

B. *Sale*

Whether the subsequent exchange of Central shares for Frontier shares pursuant to the merger agreement constituted a "sale" of the Central securities for purposes of section 16(b) poses a somewhat more difficult problem. RKO contends that the exchange did not fundamentally alter the nature of its holdings and therefore that it cannot fairly be characterized as a sale. Before the exchange, RKO urges, it owned a block of shares in each of the two separate companies; later, it was the owner of an equivalent block in the company remaining after the merger. This argument, in essence, urges us to invoke the "economic equivalence" test of *Blau* v. *Lamb*, *supra*, where we held that the conversion of preferred stock to common stock was not a sale under 16(b) since "that which the insider [surrendered]

and that which he [received were] simply different forms of the same participation in his issuer." 363 F.2d at 523. RKO's reliance on *Blau v. Lamb*, however, is misplaced. The doctrine of economic equivalence is applicable only to exchanges involving the securities of a single issuer; we stated clearly that "sales or purchases by an insider of his issuer's securities for cash, *the securities of a different company*, or other property are within the reach of Section 16(b) . . . ." 363 F.2d at 523 (emphasis added). When RKO exchanged its Central shares for Frontier securities it received "the securities of a different issuer," which represented ownership rights in the new merged airline. The "economic equivalence" exemption established by *Blau v. Lamb* is, thus, inapplicable to this case. See *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954).

The connection between the purchase of Central shares and the merger of Central and Frontier provides additional support for the view that the exchange of securities was a sufficiently meaningful event, in view of the circumstances present here, to be considered a sale. We note that RKO concedes, indeed argues strenuously, that the purchase and merger were interdependent, that the completion of each transaction was conditioned upon the consummation of the other. Given the interdependence of the purchase and the merger, it cannot be urged that RKO could simply have purchased Central securities at the contract price and sold them at a price inflated by the announcement of the impending merger. It is clear in this case, that only through the exchange provided for in the merger agreement could RKO have realized a speculative profit in Central shares.[5]

[5] As a result of RKO's holdings in Frontier, it was a "person controlling an air carrier," and its acquisition of a controlling block of the shares of another air carrier (Central) required CAB

Alternatively, RKO urges us to decide that even if the exchange was a sale, it failed to realize any profit on the transaction, and, accordingly, plaintiff was entitled to no recovery. This argument rests almost entirely on the decision in *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965), which held there were no profits realized in a conversion of securities, the rationale being that realization would occur only when the securities received in the conversion were sold for cash. The purpose of the statute, it seems to us, is quite clearly inconsistent with this narrow interpretation of "profits realized."[6] The salutary objective of section 16(b) is to prevent an insider from investing in the securities of his issuer, holding them briefly, and then divesting himself of his investment at a tidy profit. Whether, upon divestment, the insider receives cash or property should be immaterial; if the statute is to achieve

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approval. Federal Aviation Act, §408(a)(5), 49 U.S.C. §1378(a)(5). As stated above, the CAB granted its approval of the proposed acquisition, but did so on the assumption that the purchase would be followed by a merger which it found to be "consistent with the public interest." The CAB did not rule that the purchase would be permissible if it were not accompanied by the merger. Therefore, RKO would have violated the CAB's order had it purchased the Central securities, backed out of the merger, and disposed of the securities in return for cash. Under the terms of the agency's order, RKO was required to exchange the Central securities it purchased for Frontier securities pursuant to the merger agreement.

[6] In *Blau v. Lamb*, we expressly declined to follow *Heli-Coil's* treatment of the "purchase and sale" issue under section 16(b); we also refuse to follow the restrictive interpretation of "realization of profits" advanced in that case. In *Heli-Coil*, the Third Circuit was employing the "objective" approach to the applicability of section 16(b). See note 2 *supra*. It may well be that the narrow definition of "profits realized" was an attempt to avoid the harsh results which often follow from the "objective" approach, as opposed to this Court's "pragmatic" approach. *See* Hemmer, *Insider Liability for Short-Swing Profits Pursuant to Mergers and Related Transactions*, 22 Vand. L. Rev. 1101 (1969).

its end what is significant is that he has attempted to turn a short swing in the price of his issuer's securities to his own personal advantage. RKO purchased Central securities for some 7.5 million dollars. In return for these securities, it received Frontier shares worth more than 15 million dollars. The receipt of these shares was a sufficient realization of profit to place the transaction within the scope of section 16(b): See *Blau* v. *Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); *Blau* v. *Lamb*, 363 F.2d 507, 523 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

C. *Beneficial Ownership*

The final statutory provision required to be fulfilled before section 16(b) liability may be imposed on RKO is that it must have been a Central insider, in this case a ten percent beneficial owner, at the time it purchased and sold Central securities. Since RKO engaged in only a single purchase of Central securities, we are presented with the question whether the prohibition of section 16(b) embraces the very transaction which makes one a ten percent beneficial owner. Our decision in *Stella* v. *Graham-Paige Motors Corp.*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956), makes it clear that the statute is applicable to such a transaction. See 2 L. Loss, Securities Regulation 1060 (1961). This rule is grounded on the frequently cited overriding purpose of the statute, deterrence of insider trading on the basis of information unavailable to the investing public. The statutory reference to a ten percent beneficial owner rests on the presumption that an owner of this quantity of securities has access to inside information.[7]

[7] Since the stated purpose of the statute is to prevent the unfair use of information which insiders may have obtained by reason of their relationship to the issuer, the reason for including ten percent

Although this presumption would not justify the conclusion that one who purchases a quantity of shares which makes him a ten percent beneficial owner has done so on the basis of inside information, the presumed access to such information resulting from this purchase provides him with an opportunity, not available to the investing public, to sell his shares at the moment most advantageous to him. Thus, a purchase of shares which makes the buyer an insider creates an opportunity for the type of speculative abuse the statute was enacted to prevent.

Moreover, on the facts before us, we have no difficulty in deciding that RKO became a beneficial owner of more than ten percent of Central's common stock before its purchase of Central shares on September 18. On May 3 or 4, 1967, RKO entered into an agreement which granted it a conditional right to purchase more than 50% of Central's common stock at a fixed price, ensured that Central would be managed in accordance with its interests, and required a majority of Central shares to be voted in support of a merger it favored. This contract, we conclude, granted rights of ownership, particularly those rights most important to the speculative purchaser, so substantial as to make RKO a ten percent beneficial owner of Central at that time. Contrary to the assertions of RKO, this conclusion is in no way inconsistent with our decision in *Stella* v. *Graham-Paige Motors Corp.*, *supra*, that the holder of an option is not an insider until he has made a commitment to exercise the option.

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beneficial owners within the definition of insiders must have been the determination that the owner of a quantity of stock that large is likely to be privy to such information. *See* 2 L. Loss, Securities Regulation 1060-61 (1961) (ten percent beneficial owner presumed to have access to inside information).

* *Blau* v. *Ogsbury*, 210 F.2d 426 (2d Cir. 1954), a second case cited by RKO in support of the proposition that it cannot be

Stella rested on the assumption that "one who holds an unexercised option is not usually in a position to obtain [advance]-information from the company," 232 F.2d at 301, an assumption of no validity in the case before us. At the time it secured a conditional right to purchase Central securities, RKO was in possession of advance information of the type most likely to affect the price of Central shares, —confidential knowledge of an impending merger with Frontier.

Accordingly, we conclude that RKO became a Central insider, purchased Central securities and, less than six months later, sold these securities. The district court properly required RKO to return the profits it realized on this sale to Frontier, Central's successor in interest.

IV. Damages

A. *Central Debentures*

Judge Bonsal's determination of the amount of profits realized by RKO and, consequently, his award of damages to the plaintiff were based on the conclusion that the merger had constituted a sale not only of the Central common stock purchased by RKO but also of the Central debentures. These debentures, as we have indicated, were convertible into 149,994 shares of Central common stock. The court's award of damages included a sum derived from the difference between the price RKO paid for the debentures and the value of the Frontier shares for which 149,994 shares of Central could have been exchanged pursuant to the

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deemed to have been a Central insider before its purchase of Central shares, is inapposite. In that case we were called upon to decide when a buyer actually purchased shares, not when he became a beneficial owner.

merger agreement. RKO, urging that the court erred in awarding this sum as damages, points out that it neither converted the debentures into Central common stock before the merger nor converted these securities into Frontier stock after the merger. Without such a conversion, it argues, there could not have been any sale of the debentures and, hence, any profit realized.

Although this argument has surface appeal, RKO's contention distorts the nature of the transactions in which it engaged. RKO did not purchase the debentures because of their value as debt securities but because of their easy convertibility into Central common stock. The purchase price of $1,274,949 bore no relation to the debentures' face value of $500,000; rather, it was dependent upon the number of Central shares into which the debentures could be converted and the purchase price of $8.50 for each of such shares. Pursuant to section 7(b) of the merger agreement, the debentures became convertible into Frontier shares upon the consummation of the merger. Thus, although there was no physical exchange of certificates, the merger resulted in the exchange of the right to purchase Central shares represented by the debentures for the right to purchase the shares of Frontier. It is this right to purchase, rather than the debt characteristics of the debentures, which was important to RKO.[9] The district judge was therefore entirely correct in characterizing this transaction as a sale and awarding as damages the profits realized thereon.

B. *Control Premium*

RKO has no quarrel with the method the district court employed for the calculation of damages. The basic award

[9] It is interesting to note that, throughout the purchase agreement, the Central stock and debentures were characterized collectively as "the Stock."

of damages was the difference between the price RKO paid for its Central securities and the market value, on the date of the merger, of the Frontier securities RKO received in return for its holdings in Central. To this basic sum, however, the district judge added a control premium of 15 percent. The addition of this control premium, RKO contends, was erroneous.

We are of the view that the inclusion of a control premium in the damage award was justified. Cf. *Blau* v. *Lamb*, 242 F. Supp. 151 (S.D.N.Y. 1965), *rev'd in part on other grounds*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967), *noted in* 5 L. Loss, Securities Regulation 3041 (1969); *Fistel* v. *Christman*, 135 F. Supp. 830 (S.D.N.Y. 1955), *noted in* 2 L. Loss, Securities Regulation 1073-74 (1961). It is elementary that RKO could not have retained legal control of Frontier without the block of Frontier shares it received in exchange for its Central securities. At the trial on the issue of damages, Dr. Bellemore, a securities expert, provided extensive testimony concerning the value of attaining legal control. The district court thus had before it evidence that this block of Frontier shares had a special value to RKO which it would not have had to any other investor. Moreover, there was evidence that previous purchases of large quantities of Frontier shares which had conferred control on the purchaser had been at a substantial premium, ranging from 15% to 26%.[10]

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[10] To support the contention that it would not have been willing to pay a premium in order to retain its legal control over Frontier in this instance, RKO points to the contractual purchase price for Central shares, which was below, rather than above, the market price. This evidence is not convincing. It does not show, or even strongly suggest, that RKO would not have been willing to pay a premium had it been forced to do so. Indeed, the prior purchases of large blocks of Frontier shares suggest that it would have been willing to do so.

In view of all the evidence which the district judge considered, we cannot characterize as clearly erroneous his finding that the block of shares RKO received in exchange for its Central securities was 15 percent more valuable to it than to the average investor in the marketplace.

Affirmed.

APPENDIX B

Opinion of the District Court

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

KAUFMAN, TAYLOR, KIMMEL & MILLER, ESQS.,
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TYLER, D.J.

This action under Section 16(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78p(b)) raises some of the questions left unresolved by the Court of Appeals for the Second Circuit in *Blau* v. *Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied* 385 U.S. 1002 (1967), that court's most recent in-depth excursion into the complicated world of short-swing insider profits.

Plaintiff's claim arises out of the events surrounding the 1967 merger of Central Airlines, Incorporated ("Central") into Frontier Airlines, Inc. ("Frontier"), the surviving corporation being Frontier. (For convenience, I will refer to the merged corporation as "Central-Frontier.") Plain-

tiff, a Frontier security holder,[1] claims that RKO General, Inc. ("RKO") realized short-swing insider profits in transactions in Central common stock and convertible debentures, and that the claim now belongs to Central-Frontier as a result of the merger. At all relevant times, Central common was traded over-the-counter.

With the material facts undisputed, defendant RKO has moved for summary judgment, and plaintiff has cross-moved for summary judgment on the issue of liability, reserving for future determination the calculation of the exact amount of profits claimed to have been realized by RKO.[2]

I

FACTS

During the period immediately preceding April 5, 1967, RKO held 56% of the outstanding common stock of Frontier and was in the process of negotiating a merger between Frontier and Central. On that date, the management of the two airlines agreed in principle to a merger of Central into Frontier with an exchange ratio of one share of Frontier common stock for each 3½ shares of Central common stock. On May 3 or 4, 1967, RKO contracted with a small number of major Central stockholders to purchase 738,251 shares

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[1] In an affidavit verified on April 4, 1968, plaintiff avers that since April, 1967, she has been the owner of Frontier 5½% debentures in the face amount of $2,000 and warrants entitling her to purchase Frontier common.

[2] Rule 56(c), F.R.Civ.P. Although the failure to show the existence of profits will preclude the grant of summary relief on the issue of liability, see *e.g., Blau* v. *Lamb*, 163 F. Supp. 528, 532 (S.D.N.Y. 1958), once the existence of profit has been established, a court may enter partial summary judgment reserving for trial the issue of the amount of damages. See *Roth* v. *Fund of Funds, Ltd.*, CCH Fed. Sec. L. Rep. 92,147 (S.D.N.Y. 1968); 2 Loss, Securities Regulation 1049 (2d ed. 1961).

of Central common, representing 49% of Central's outstanding shares, plus $500,000 principal face amount of Central convertible debentures, which were convertible into an additional 149,994 shares of Central common.[3] The purchase was to be at the effective rate of $8.50 per share of common stock. As a part of this agreement, RKO acquired the promises of Central shareholders owning approximately 66% of the Central common that they would vote the shares in favor of the merger. At the time of the execution of this purchase agreement, neither the public nor the stockholders of the two corporations had been informed of the proposed merger.

On May 4, 1967, the two airlines executed a formal agreement of merger at the previously agreed upon exchange rate. A press release on the merger agreement was issued the same day. The next day, May 5, 1967, reports in the financial press described the merger based on the press release, and disclosed to the public RKO's contract with the Central security holders.

The necessary approval of the merger by shareholder majorities of the two airlines was obtained on July 27, 1967. On the same date, the Frontier shareholders ratified a two-for-one split of Frontier common stock, which had been declared by Frontier's board of directors on May 10, 1967. To compensate for the stock split, the terms of the merger were adjusted to provide for an exchange rate of two shares of Frontier for each 3½ shares of Central.

The requisite Civil Aeronautics Board ("CAB") approval of the merger became effective on September 1, 1967, subject to the written acceptance by Frontier of certain conditions.

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[3] It should be apparent from the fact that these debentures were convertible into over $1.2 million worth of common stock that the market value of the debentures was virtually dependent upon the market value of Central common stock. The parties do not dispute that these debentures were "equity" securities.

Thereafter, on September 18, 1967, RKO received the Central stock and convertible debentures for which it had previously contracted and paid a total purchase price of $8,550,082.50. On the same day, the merger agreement was filed with the Secretary of State for the State of Nevada, where both Frontier and Central had been incorporated.[4] The CAB received notice of Frontier's acceptance of the regulatory board's conditions to the merger on September 20, 1967. At the same time, Frontier requested that the CAB transfer Central's certificate of public convenience effective October 1, 1967.

Apparently it was on October 1, 1967, that the exchange of securities between Central and Frontier was consummated. In exchange for its Central common stock and convertible debentures, RKO received 420,850 shares of Central-Frontier common and Central-Frontier debentures convertible into 85,831 shares of Central-Frontier common.

On the basis of these facts, plaintiff contends that RKO's acquisition of Central securities and subsequent disposition within six months in the course of the merger with Frontier falls squarely within the proscription of Section 16(b). RKO raises some eight separate rebuttals to this basic contention of plaintiff. The first three, which will be dealt with in Part II of this opinion, are arguments that plaintiff has failed to establish three elements of its Section 16(b)

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[4] RKO contends that the merger became effective under Nevada law upon this filing. Plaintiff disagrees, relying upon the terms of the merger agreement and the CAB order. She claims that the merger did not become effective until October 1, 1967. Since neither date is beyond six months from May 3, 1967, the disagreement and argument here apparently go only to the questions of which date should be used to determine the specific amount realized by RKO and its disposition of Central stock. Irrespective of which date is chosen, the amount is certainly greater than the $8,550,082.50 which RKO paid to acquire the securities. Def.'s Brief, p. 15.

claim—"purchase", "sale", and "profit realized". The final five arguments are a variety of defenses based on administrative rules, federal statutes, and common law principles. This group of arguments will be discussed in Part III of the opinion.

II

"PURCHASE", "SALE", AND "PROFIT REALIZED"

Defendant aims at the jugular of this claim under Section 16(b), 15 U.S.C. §78p(b),[5] by arguing that none of the primary elements of such a claim has been established by the facts in this case. Although there is a variety of factual and legal arguments made by RKO on these three points, a common thread can be discerned. Defendant consistently maintains that the transactions already described do not present a situation which lends itself to the type of insider abuse that Section 16(b) was designed to prevent.

The most hotly contested issue in this case is whether there was a "sale" of the Central securities, but it will be

[5] "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . . This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

helpful to consider the "purchase" issue first since its outcome has some effect upon points raised in the main question. Defendant admits, as it must, that under any normal meaning of the word, it made a "purchase" of the Central securities for cash on September 18, 1967. (Def.'s Brief, p. 29.) But, it argues, "the substance of the transaction and the intent of the parties was that RKO was not purchasing shares of Central but shares of [Central-Frontier]." Even if I were to concede that such was the sole purpose of the parties to the transactions, Section 16(b) was designed to protect the investing public and shareholders other than the ones involved in the particular acquisitions and dispositions of shares. While RKO was probably primarily concerned with the merger and with maintaining its dominant position in Frontier, the method it used to effectuate its purpose was the acquisition of the common stock and convertible debentures of Central. In view of the purposes of Section 16(b) to protect against short-swing insider dealings in equity securities regardless of the subjective purpose of the insider, I must reject this novel argument. I find that plaintiff has established that there was a "purchase" of Central securities by RKO.

As I have noted, the central issue is whether the exchange of RKO's Central securities for securities of Central-Frontier was a "sale" within the meaning of Section 16(b). Under the "automatic" or "rule of thumb" test of *Park & Tilford, Inc.* v. *Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied* 332 U.S. 761 (1947), and its progeny,[6] this exchange

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[6] The approach taken in *Park & Tilford* has been followed relatively recently. See, e.g. *Western Auto Supply Co.* v. *Gamble Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied* 382 U.S. 987 (1966); *Heli-Coil* v. *Webster*, 352 F.2d 156 (2d Cir. 1965); but see *Pettys* v. *Butler*, 367 F.2d 528 (8th Cir. 1966), *cert. denied* 385 U.S. 1006 (1967).

clearly would have fallen within the ambit of the statute since RKO owned Central securities before the merger but did not afterward. But the "rule of thumb" test has been discarded in this Circuit in favor of the so-called "pragmatic" test, *Blau* v. *Lamb*, 365 F.2d 507 (2d Cir. 1966), *cert. denied* 385 U.S. 1002 (1967), and this test appears to be the criterion that will govern in other Circuits, *Pettys* v. *Butler*, 367 F.2d 528 (8th Cir. 1966), *cert. denied* 385 U.S. 1006 (1967). After a survey of the legislative history of Section 16 and a distillation of the important decisions in this particular area, the Court of Appeals for the Second Circuit articulated the rule "whether the transaction in any way makes possible the unfair trading that Section 16(b) was designed to prevent." *Blau* v. *Lamb*, *supra*, at 518. This rule, although it is less than automatic in its application, still has the advantage of being objective, because once the possibility of insider abuse is found to exist Section 16(b) must be applied irrespective of any actual abuse. *Id.*, at 516.

As I understand it, defendant makes two basic arguments grounded upon *Blau* v. *Lamb*. The first is that the exchange in question was tantamount to the type of conversion of convertible securities into underlying common that existed in *Blau* v. *Lamb* and other similar cases. *Pettys* v. *Butler*, 367 F.2d 528 (8th Cir. 1966), *cert. denied* 385 U.S. 1006 (1967); *Blau* v. *Max Factor & Co.*, 342 F.2d 304 (9th Cir.), *cert. denied* 382 U.S. 892 (1965); *Ferraiolo* v. *Newman*, 259 F.2d 342 (6th Cir.), *cert. denied* 359 U.S. 927 (1958); *Blau* v. *Mission Corp.*, 212 F.2d 77 (2d Cir. 1954); *Roberts* v. *Eaton*, 212 F.2d 82 (2d Cir.), *cert. denied* 348 U.S. 827 (1954). The second argument is based on the theory that the pragmatic test should be extended beyond the "economic equivalent" situations to cover the facts of this case.

Each of the cases on which defendant relies for its first argument involve either the conversion, *Ferraiolo* v. *Newman, supra; Blau* v. *Max Factor, supra; Pettys* v. *Butler, supra,* or reclassification, *Roberts* v. *Eaton, supra; Blau* v. *Mission Corp., supra,* of one class of an insurer's securities into another of the same issuer. The basis for the conclusion in these cases, clearly set out in *Blau* v. *Lamb,* 363 F.2d at 521-522, is that the two types of stock were virtual economic equivalents and the conversion or reclassification did not present an additional opportunity for insider abuse. RKO contends that the securities which it gave up and those which it received were virtually economic equivalents.

Initially, I question whether an exchange of two different issuers' securities could ever present the "economic equivalence" issue that appears to be the heart of the cases on which RKO relies. My reading of *Blau* v. *Lamb* indicates to me that the economic equivalence on which the court based its reasoning was the objective, clearly demonstrable, market inter-changeability of the two types of securities. It would seem to be nearly impossible to demonstrate such economic equivalence where the issuers are substantially different companies. *Cf. Blau* v. *Mission Corp., supra.* As the *Blau* v. *Lamb* court stated:

> ". . . sales or purchases by an insider of his issuer's securities for cash, *the securities of a different company,* or other property are within the reach of Section 16(b), even though, if these are arms-length transactions, each side will receive what it considers to be at least economically equivalent to what it surrenders. Focus on the factor of economic equivalence is only relevant when—as in a conversion or a

> reclassification—that which the insider surrenders and that which he receives are simply different forms of the same participation in his issuer." (Emphasis added.) 363 F.2d at 523.

Upon this reasoning and definition of economic equivalence, I conclude that RKO is incorrect in its argument that in this case there was an "exchange" of different forms of the same participation in the issuer.

But an even more fundamental difficulty confronts RKO on this point. It is abundantly clear that the 49% holding of Central common stock before the merger is in no way equivalent to the 20-25% holding of Central-Frontier common stock which it received in exchange.[7] RKO vigorously contends that the court should take into account its prior ownership of 56% of the common stock of Frontier in considering the economic equivalence of the securities exchanged. Briefly stated, its argument is that after the merger,

> "[RKO] still held an equity position in a local service airline, which was no more than the sum of its equity position in both lines prior to the merger, and that equity position was at all times subject to the vicissitudes of the market place." Def.'s Brief, p. 26.

I reject this argument for two reasons. First, RKO's holdings of Frontier furnished no assurance to the stockholders of Central that the value of their securities would be adequately protected in the merger. Second, as is true in so

[7] Although the analysis pertains only to the transactions in common stock, it is equally applicable to transactions in the convertible debentures.

many mergers, the record indicates that the resulting corporation was more than the sum of its constituent parts.[8]

Defendant makes an independent argument from *Blau* v. *Lamb* based on the general principle that no "sale" will be found where the transaction does not admit of the possibility of insider abuse. Basically, RKO urges that by the time it became an insider under the statute, and hence was presumed to have inside information, it was "locked into" the merger at the 1 for 3½ ratio, and could not possibly use any insider information it might have acquired.

Defendant rests this argument upon two cases decided some time ago by the Court of Appeals for this Circuit, *Blau* v. *Ogsbury*, 210 F.2d 426 (2d Cir. 1954) and *Stella* v. *Graham-Paige Motors Corp.*, 232 F.2d 299 (2d Cir.), *cert. denied* 352 U.S. 831 (1956). A brief discussion of these two cases will be helpful.

In *Ogsbury*, the defendant director-officer had been awarded a non-assignable option to purchase 10,000 shares of the company's common stock as a part of his compensation. The option was exercised in December, 1945, but the actual exchange did not take place until December, 1948. In refusing to accept plaintiff's argument that the "purchase" occurred in December, 1948, the court held that the date of exercise was the date of "purchase" because defendant then "incurred an irrevocable liability to take and pay for the stock." 210 F.2d at 427. In elaborating its reasoning, the court stated:

> ". . . It matters not to the speculator who had title or possession or who can vote the stock or receive dividends. What he needs is firm assurance that a fixed

[8] As the CAB examiner stated, ". . . [I]t is clear that the combined operations of Frontier and Central will be more profitable than the operation of two carriers as separate entities . . ."

> quantity can be acquired or disposed of at a fixed price; and speculation, actual or potential, is the only vice within the purview of 16(b). . . ." 210 F.2d at 427.

Although the language would appear to indicate that the date of purchase was the date on which the option was granted, the court was not required to reach that question since the December, 1945, date was outside the statutory period of six months and was sufficient to allow summary judgment for defendant.

The court was presented with a somewhat different factual pattern in *Stella*. There the defendant had contracted to purchase the statutory 10% of the company's common stock subject to the condition that it receive a loan from a named bank to pay for the securities. The court rejected the defendant's contention that the date of the contract was the date of purchase. It held that the "purchase" could not occur until the condition precedent had been fulfilled. The court also rejected Graham-Paige's argument that it could not be considered an insider at the time of the purchase which made it a "beneficial owner" of over 10% of the common stock of the corporation.

The court went on to consider a question wholly unnecessary for its decision, whether or not Graham-Paige had become a "beneficial owner" of the securities at the date of the contract. Its reasoning on this point was as follows:

> "In *Blau* v. *Ogsbury; supra,* the question was when the holder of an option to buy stock became the 'beneficial owner.' We held that it was not (a) the date when he acquired the option, nor (b) the day when, having exercised it, he paid for the stock and obtained legal title to it, but (c) the day when he

> exercised the option with the result that he had then a fixed right and obligation under an executory contract. See also *Park & Tilford* v. *Schulte*, 2 Cir., 160 F.2d 984, 987 where we said that, upon the exercise of an option, the optionee becomes an 'insider' and thus within the Congressional purpose to 'protect the outside stockholders against at least short-swing speculation by insiders with advance information.' Our reasoning was that one who holds an unexercised option is not usually in a position to obtain such information from the company. Here Graham-Paige, as long as it had an election to back out of the agreement to purchase, was not an 'insider' under Section 16(b)." 232 F.2d at 301.

With due respect, I believe that the two cited bases for the court's dictum give no support for the conclusion reached. As I have pointed out, the defendant in *Blau* v. *Ogsbury* was a director-officer; hence, the court had no legal reason to consider the date on which he became a "beneficial owner" under the statute. The citation of *Park & Tilford* in the above quotation is no more helpful because the holding in that case was that the conversion of convertible preferred into common was a "purchase" within the meaning of the statute.

The obvious unstated assumption in the quoted dictum from *Stella* is that one cannot become a "beneficial owner" until the "purchase" which gives him more than 10% of the class of security. Although the court in *Ogsbury* and *Stella* was not directly faced with this question, I believe that it is presented squarely by the facts of this case.

On May 3 or 4, 1967, after executing the contract to purchase the Central securities, RKO was in the following position. It held an option to buy a very substantial num-

ber of Central securities at the equivalent price of $8.50 per share on the condition that the merger was consummated. It could rely upon the exchange ratio of one share of Frontier for each 3½ shares of Central. Thus, the condition precedent to its obligation to purchase the shares was the same occurrence which concluded the disposition of he Central securities. Moreover, under the contract RKO had the obligation to process the merger through the federal regulatory procedures of the CAB.

With this brief background in mind, the date on which the inside information became available to RKO as a "beneficial owner" of Central securities must be decided. In my view, the pragmatic approach outlined in *Blau* v. *Lamb* compels the conclusion that RKO was a "beneficial owner" and presumably had inside information on May 3 or 4, 1967, when it contracted to acquire the Central securities on the sole condition that the merger be completed. See, Feldman & Teberg, *Beneficial Ownership under Section 16 of the Securities Exchange Act of 1934*, 17 West. Res. L. Rev. 1054, 1083-1095 (1966). I might add, without necessarily disagreeing with the dictum of the *Stella* court,[9] that it would tax the credulity of this court to believe that RKO did not in fact have inside information at the contract date by reason of its relationship with Central. See, Feldman & Teberg, *supra*, at 1090.

I turn now to the ultimate question under the rubric of *Blau* v. *Lamb*—did the disposition of these securities in any way allow the abuse of inside information which Section 16(b) was designed to prevent? I believe that it did in at least two ways. First, at the time the contract was

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[9] The court stated flatly, "that one who holds an unexercised option is not usually in a position to obtain [inside] information from the company." 232 F.2d at 301.

made to acquire the Central securities, RKO was or could have been "gambling" that the established exchange ratio would turn out to be more advantageous than its effective purchase price of $8.50 per share. The second possibility of the misuse of inside information is a result of the fact that RKO could influence the speed and timing of the merger, and possibly its outcome. In this connection, two uncontroverted facts are pertinent: first, RKO had a very significant interest in both airlines before the merger, and thus as a practical matter may have been able to force abandonment of the merger; and, second, RKO had to specifically consent to certain conditions placed on the merger by the CAB because it controlled Frontier. Under the circumstances, I must conclude that there was a possibility of RKO's use of inside information.

There is no need to deal extensively with RKO's argument, derived from language in *Roberts* v. *Eaton*, 212 F.2d 82, 85-86 (2d Cir.), *cert. denied* 348 U.S. 827 (1954) and *Shaw* v. *Dreyfus*, 172 F.2d 140 (2d Cir.), *cert. denied* 337 U.S. 907 (1949), that since shareholders of Central were treated the same in the merger, there was no possibility of insider abuse. All shareholders were not treated the same, since none but RKO was afforded the opportunity to acquire stock or contract for its acquisition on May 3 or 4, 1967, at what turned out to be the bargain price of $8.50 per share. *Marquette Cement Mfg. Co.* v. *Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965). Nor does the fact that all Central shareholders may have benefitted from an increase in the value of their shares because of the merger aid defendant.

Finally, RKO argues that even if there was a "purchase" and a "sale" within the statutory period, there was no "profit realized". The primary basis for this argument

is another of the conversion cases, *Heli-Coil Corp.* v. *Webster*, 352 F.2d 156 (3d Cir. 1965). In that case, the court took the "automatic" approach in finding that a conversion from a convertible preferred to common was a "sale" of the convertible preferred, but found that there was no "profit realized" on the transaction. I note that in *Blau* v. *Lamb* the Court of Appeals criticized the approach taken on the "sale" question in *Heli-Coil*: 363 F.2d at 519-520. Moreover, the reasoning of the Third Circuit on the question of "profit realized" can be understood as an attempt to mitigate the inflexibility of the "automatic" test by coming to grips with the economic facts with which the Second Circuit was dealing in *Blau* v. *Lamb*. Since these economic factors have been analyzed hereinabove, reconsideration of the same points under this point is unnecessary.

In summary, it is ruled that plaintiff has established the three contested elements of its Section 16(b) claim.

III.

STATUTORY AND COMMON LAW DEFENSES

Defendant raises five "defenses", any one of which would immunize it from Section 16(b) liability if accepted by this court, despite the result already reached in Part II of this opinion. The most seriously asserted of these defenses is that this transaction is exempted from operation of the statute by Section 414 of the Federal Aviation Act, 49 U.S.C. § 1384, which states:

> "Any person affected by any order made under sections 1378, 1379, or 1382 of this title shall be, and is hereby, relieved from the operations of the 'anti-trust laws', as designated in section 12 of Title 15,

> and of all other restraints or prohibitions made by, or imposed under, authority of law, insofar as may be necessary to enable such person to do anything authorized, approved, or required by such order."

Defendant is correct in asserting that the immunity it urges flows from the statute, if at all, and that there is no requirement that the CAB have specifically exempted it from Section 16(b). See, *Brotherhood of Locomotive Engineers* v. *Chicago & Northwestern Ry. Co.*, 314 F.2d 424, 432 (8th Cir. 1963). I must therefore consider the question whether Section 414 was intended to protect persons affected by a CAB order from a Securities Exchange Act claim under Section 16(b).

Delicate problems are often presented to a court hearing a federal claim against a party which is subject to a comprehensive regulatory scheme enacted by Congress. See, *e.g.*, *Pan American World Airways, Inc.* v. *U. S.*, 371 U.S. 296 (1963). But I think that this issue can be resolved by a relatively straight-forward interpretation of Section 414, thus avoiding the broader question of possible conflict between the federal aviation laws and the federal securities laws. See 2 Loss, *Securities Regulation* 427, n. 215 (2d ed. 1961).

Section 16(b) is a unique regulatory measure in that it purposely includes within its reach some innocent dealings in order to discourage transactions in an area in which abuse was rampant. *Blau* v. *Lamb*, 363 F.2d 507, 515 (2d Cir. 1966), *cert. denied* 385 U.S. 1002 (1966). Thus, the Congress did not prohibit short-swing transactions entirely, but provided only that the corporation could recover profits. See *Adler* v. *Klawans*, 267 F.2d 840, 844 (2d Cir. 1959). Therefore, an insider like RKO is in no way precluded

from executing short-swing purchases and sales by Section 16(b).

I assume without deciding that Section 16(b) is a "restraint of law" within the meaning of Section 414, set out above. But the statute immunizes RKO only "insofar as may be necessary to enable [RKO] to do anything . . . approved . . . by such order." 49 U.S.C. § 1384, *supra*. Because of the peculiar method used by Congress in Section 16(b) of the Exchange Act, RKO was capable of legally completing the merger. Although it is presumably true, as defendant argues, that it "would undoubtedly not have proceeded with the merger if subject to a suit of the present type," there was nothing in Section 16(b) which prevented it from doing so. In other words, I see no direct conflict between Section 16(b) of the Exchange Act and the power of the CAB to approve mergers. See, *Trans World Airlines, Inc.* v. *Hughes*, 332 F.2d 602, 608 (2d Cir. 1964).

Defendant also claims that the Securities Exchange Commission ("SEC"), pursuant to its statutory authority, 15 U.S.C. § 78p(b), has exempted this transaction from the operation of Section 16(b) as not within the statutory intent. The first rule under which it claims is Rule 16b-7(a) (3), 17 C.F.R. § 240.16b-7, which is set out in the margin.[10] The short answer to defendant's argument is that it

[10] "(a) The following transactions shall be exempt from the provisions of section 16(b) as not comprehended within the purpose of said subsection:

* * *

(3) The acquisition of a security of a company, pursuant to a merger or consolidation, in exchange for a security of a company which, prior to said merger or consolidation, held over 85 percent of the combined assets of all the companies undergoing merger or consolidation, computed according to their book values prior to the merger or consolidation as determined by reference to their most recent available financial statements for a 12-month period prior to the merger or consolidation."

did not acquire "a security of a company . . . in exchange for a security of a company which, prior to said merger . . . held over 85 percent of the combined assets . . .". RKO acquired Central-Frontier shares in exchange for Central shares. Central certainly did not own over 85% of the combined book value assets.

RKO also claims an exemption under Rule 16b-9(a), 17 C.F.R. § 240.16b-9, which is set out below.[11] This rule covers by obvious intent and plain language the conversion of one class of equity securities of an issuer into another of the "same issuer". I reject RKO's argument that Central-Frontier is the "same issuer" as Central, for reasons that should be obvious from my discussion of defendant's argument on this point at the outset of Part II of this opinion.

Defendant raises two final defenses which have no merit. It argues that the very occurrence which we have found to be a "sale" was the cessation of the existence of Central and, therefore, the Section 16(b) claim never accrued to Central.[12] Suffice it to say that the claim accrued to Central at the moment of the operation of the merger. Acceptance of defendant's argument would create an unwarranted loophole in the law of Section 16(b) as applied to mergers. Finally, defendant claims that the overwhelming approval of the merger by the shareholders of both airlines operates to estop Central, and hence plaintiff, from asserting this claim. I reject this argument since it is the law of this Circuit that estoppel principles are inapplicable

[11] "(a) Any acquisition or disposition of an equity security involved in the conversion of an equity security which, by its terms or pursuant to the terms of the corporate charter or other governing instruments, is convertible immediately or after a stated period of time into another equity security of the same issuer, shall be exempt from the operation of section 16(b) of the Act . . ."

[12] RKO concedes that claims which accrued to Central now belong to Central-Frontier. Def.'s Brief, pp. 51-52.

to Section 16(b) claims. *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962, 966 (S.D.N.Y. 1965) and cases cited therein.

IV.

CONCLUSION

Plaintiff has established its Section 16(b) claim as a matter of law on the undisputed facts of this case. Therefore, I direct entry of summary judgment on the issue of liability in favor of plaintiff and deny defendant's motion for summary judgment.

It is so ordered.

Dated: New York, N. Y.
December 6, 1968.

H. R. Tyler, Jr.
U.S.D.J.

APPENDIX C

Opinion of the District Court

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

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OPINION

BONSAL, D.J.

Plaintiff, a shareholder of Frontier Airlines, Inc. (Frontier), a Nevada corporation, brought this action under Sec-

tion 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), to recover on behalf of Frontier, "short-swing" profits allegedly realized by RKO General, Inc. (RKO), an "insider" of Frontier.

In an opinion reported at 294 F.Supp. 358 (S.D.N.Y. 1968), Judge Tyler held that, on the undisputed facts, plaintiff stated a claim under Section 16(b), that RKO was liable to plaintiff for the short-swing profits realized, and that the only issue for trial was the amount of the profit realized by RKO.

The issue of the amount of profit was tried before the court, without a jury.

The undisputed facts, upon which Judge Tyler found liability, are as follows:

On April 5, 1967, RKO owned 56% of the outstanding common stock of Frontier. On that date, Frontier and Central Airlines, Inc. (Central), a Nevada corporation, agreed in principle to a merger of Central into Frontier with an exchange ratio of one share of Frontier common stock for each 3½ shares of Central common stock.

In early May 1967, RKO contracted with a small number of major Central shareholders to purchase 738,251 shares of Central common stock, representing 49% of Central's outstanding shares and $500,000 principal face amount of Central convertible debentures, which were convertible into an additional 149,994 shares of Central common (hereinafter, the Central securities). The purchase of the common stock was made at the rate of $8.50 per share of common stock; the purchase of the debentures was made at the rate of $8.50 per share of the common stock into which the debentures were convertible. As a part of the purchase agreement, Central shareholders owning approximately 66% of the Central common stock promised that they would vote their shares in favor of the merger. At the time of the

execution of the purchase agreement, neither the public nor the other shareholders of the two corporations had been informed of the proposed merger.

Thereafter, on May 4, 1967, Central and Frontier executed a formal agreement of merger at the previously agreed upon exchange ratio, viz., 3½ shares of Central for one share of Frontier. A press release on the merger agreement was issued that day, and the next day reports based on the release described the merger agreement and disclosed the existence of RKO's contract with the Central shareholders to purchase the Central securities.

On May 10, 1967, Frontier's Board of Directors declared a two-for-one split of Frontier common stock.

On July 27, 1967, the shareholders of Central and Frontier approved the merger and the Frontier shareholders ratified the 2-1 split of Frontier common stock, the terms of the exchange ratio being adjusted to compensate for the stock split by providing an exchange ratio of two shares of Frontier common stock for each 3½ shares of Central common stock.

On September 1, 1967, subject to certain conditions to be accepted by Frontier, the Civil Aeronautics Board's (CAB) approval of the merger became effective. Thereafter, on September 18, 1967, RKO received the Central securities for which it had contracted with the Central shareholders and paid a total purchase price of $7,550,082.50. On the same day, the merger agreement was filed with the Secretary of State of the State of Nevada. On September 20, 1967, the CAB received notice of Frontier's acceptance of the conditions referred to above and Frontier's request that the CAB transfer Central's certificate of public convenience to Frontier, effective October 1, 1967.

On October 1, 1967, the exchange of securities between Central and Frontier took place. In exchange for its Central

securities, RKO received 421,857 shares of the new Frontier common stock and new Frontier debentures convertible into 85,714 shares of the new Frontier common stock (hereinafter, the Frontier securities).

Judge Tyler found that RKO purchased the Central securities in early May 1967; that RKO sold its Central securities when it exchanged them for the new Frontier securities on September 18, 1967, or October 1, 1967; and that RKO realized a profit by its sale of the Central securities.

Since RKO purchased the Central securities for $7,550,082.50 ($8.50 per share times 738,251 shares of common stock, and $8.50 per share times debentures convertible into 149,994 shares of common stock),[1] the measure of its

[1] RKO contends that an increment of $5.25 must be added to the purchase price of $8.50 per share, which increment represents the difference between the sale price of Central on the date the contract to buy was exercised, September 18, 1967, and the sale price on the date the contract was executed, around May 4, 1967. However, in his opinion, Judge Tyler found uncontested the fact that the price RKO actually paid was $8.50 per share, not $13.75 per share. Furthermore, the so-called employee stock option cases, cited by RKO, are inapplicable here, since RKO did not render any services to Central during the period in question, nor was the option to buy granted so as to stimulate RKO's efforts on behalf of Central. Furthermore, RKO did not contract to buy from Central, but from individual Central shareholders. Compare *Truncale* v. *Blumberg*, 88 F. Supp. 677 (S.D.N.Y. 1950). See generally, Green and Kelly, *Application of Section 16(b) to Insiders' Transactions under Employee Stock Option Plans*, 17 Bus. Law. 402 (1962), reprinted in American Bar Association, *Selected Articles on Federal Securities Law* 667 (1968). Therefore, the court adheres to Judge Tyler's statement that "on September 18, 1967, RKO received the Central stock and convertible debentures for which it had previously contracted and paid a total purchase price of $8,550,082.50 (sic)," 294 F. Supp. 358, 360.

RKO also contends that the contract to purchase Central debentures should be excluded entirely from the computations. However, Judge Tyler held that the convertibility aspects of the transaction did not provide an exemption from liability under *Blau* v. *Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967),

profit depends on the sales price, viz., the value of the Frontier securities received in exchange for the Central securities. *Park & Tilford, Inc.* v. *Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); *Blau* v. *Mission Corporation*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954).

Plaintiff contends that the appropriate date for determining the fair market value of the Frontier securities is September 18, 1967, when the merger agreement was filed with the Secretary of State of Nevada. Defendant argues that the appropriate date is October 2, 1967, the first market day after the securities were physically exchanged.

The date of October 1 (or October 2), 1967, has no relevance to the issue of fair market value, since the only thing which occurred at that time was the exchange of certificates, a "mechanical detail." 2 Loss, *Securities Regulation* 1071-2 (2d ed. 1961). Furthermore, Nevada law provides that the filing date of a merger is the effective date of the merger. §78.495, Nevada Revised Statutes. Therefore, the court finds that the appropriate date for determining fair market value is September 18, 1967, when the merger agreement was filed.

Both plaintiff and defendant offered expert testimony as to fair market value on September 18, 1967.

Plaintiff's expert, Dr. Douglas Bellemore, investment analyst and a professor of finance at New York University Graduate School of Business Administration, testified that

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or under Rule 16b-9, 17 C.F.R. 240.16b-9, upon which RKO relies, see 294 F. Supp. at 362, 367. See generally, Lang and Katz, *Liability for "Short Swing" Trading in Corporate Reorganization*, 20 Sw.L.J. 472 (1966), reprinted in A.B.A., *Selected Articles on Federal Securities Law* 679 (1968). It follows from Judge Tyler's holding that the convertible debentures must be included in the computation of profit realized.

the market value of a stock is the value per share at which the stock is traded between informed buyers and sellers under no compulsion to buy or sell. Such trades occur on national stock exchanges, such as the New York or American Stock Exchanges, when there is a "good continuous market, an orderly market . . . with frequent transactions, reasonable volume . . . and not too significant spreads between the prices of the transactions."

Dr. Bellemore testified that in 1967 the market in Frontier common stock, listed on the American Stock Exchange, satisfied these conditions, and that the market price of Frontier on a given day corresponded quite closely to its market value. On September 18, 1967, the average market price for Frontier was 26⅛ (high: 26½; low: 25¾). However, Dr. Bellemore testified that, in his opinion, the average market price did not represent the fair market value of the Frontier stock to RKO because of the control factor. Prior to the merger, RKO owned 56% of Frontier common stock. Had RKO not acquired the Central securities, its percentage of ownership upon the merger becoming effective would have dropped from 56% to 43%.[2] By acquiring

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[2] On September 18, 1967, before the merger became effective, RKO owned 1,632,404 shares of Frontier common stock, or 56.02% of the 2,914,006 shares outstanding (after adjustment for 2-1 split). After the merger, there were to be 3,774,940 shares of Frontier common outstanding, of which RKO would own the same 1,632,404, or 43.42%.

Dr. Bellemore testified that if RKO had not acquired the Central securities and if all outstanding warrants and options on Frontier common stock were exercised (equivalent to 1.6 million shares), RKO's percentage of ownership would drop to 30% (RKO's ownership of about 1.6 million is 30% of the total of 3.7 million outstanding plus the additional 1.6 million from warrants and options). There was no testimony as to what RKO's percentage of ownership would be after the merger and after its acquisition of the Central securities if all warrants and options were exercised, but using the same figures, it appears that RKO's percentage of ownership would be 40% (RKO's ownership of 2.1 million after the merger

738,251 shares of Central which were exchanged for 421,857 Frontier shares, and debentures which became convertible into 85,714 Frontier shares, RKO was able to maintain its percentage of ownership of Frontier common stock at 56%.[3]

In Dr. Bellemore's opinion, the maintenance of its 56% control through the purchase of the Central securities and their exchange for Frontier securities at the time of merger was valuable to RKO, for which RKO would be willing to pay a premium above market price.

Dr. Bellemore testified that on previous occasions purchasers of the so-called "control factor" in Frontier, including RKO, had paid premiums ranging from 15% to 28% above market prices,[4] and he concluded that RKO would be willing to pay 15% above the market price on September 18, 1967, for the Frontier securities which would enable it to re-

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is 40% of the total of 3.7 million outstanding and 1.6 million from options and warrants). However, this percentage is not relevant inasmuch as it is clear that RKO's object was to buy enough Central securities so that after the merger it would maintain its percentage of ownership of the outstanding common stock at 56%, without taking into consideration the options and warrants, which might in the future be exercised.

[3] After the merger, RKO owned its original 1,632,404 shares, plus 421,857 converted from Central common, and 85,714 converted from Central debentures, for a total of 2,139,975, out of 3,774,940 shares outstanding, or 56.69%.

[4] In March 1962, the Goldfield Consolidated Mines Company (later changed to The Goldfield Company) purchased from the Maytag family 625,046 shares of Frontier common, or 66.3%, for "investment purposes" at an average price of $4.80 per share, while the market price was 3¾ bid, 3⅞ asked, which price indicates a premium of approximately 26%.

In November 1964, RKO purchased from Goldfield 651,308 shares of Frontier common, or 54.1%, for "investment purposes" at a price of $10 per share, which was $1.375 above market price, or a premium of 15%.

In December 1964, RKO purchased 16,341 shares of Frontier common from Frontier at $10 per share. These shares had previously been held by Frontier as treasury shares and the premium paid was approximately 20%.

tain its 56% control. Using the high price of Frontier (26½), *Smolowe* v. *Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied* 320 U.S. 751 (1943), and adding the premium factor of 15%, the fair market value of the block of Frontier securities on September 18, 1967 was $15,470,764., and the realized profit to RKO on that date was $7,920,681. (or a cost of $7,550,082.).

RKO's expert, Edward F. Dugan, Vice-President and director of Smith, Barney & Company, investment bankers, testified that he specialized in airlines and that among the accounts he has worked on since joining Smith, Barney in 1961 was RKO's successful bid to take control of Frontier in 1964, Frontier's successful financing of a $15 million public offering of debentures with warrants in March 1967, and Frontier's $20 million offering of convertible debentures in October 1967. Dugan testified that the bulk of his work had been with small airlines, like Frontier and Central.

Dugan testified that in evaluating the value of a block of securities, such as the block of over 500,000 shares of Frontier involved here, he would consider the following ten elements: 1) the quoted market price; 2) where the stock is traded; 3) the size of the block relative to the number of shares outstanding and the trading activity in the stock; 4) whether the stock was freely tradeable or was restricted by "investment purpose" representations; 5) the identity of the seller; 6) any governmental restrictions on sale, such as the need for approval by the CAB; 7) recent price movements in the stock; 8) price-earnings (P/E) ratio of the stock relative to other stocks in the same industry; 9) the financial trend of the company; 10) the general trend in the market.

Dugan testified that in light of these factors the fair market price of the Frontier securities received by RKO on

September 18, 1967 was 40% to 50% less than the market price, for the following reasons:

First, the value would be reduced by about 20% because the stock was not registered with the SEC and "therefore the buyers must give investment representations in order to buy it." Furthermore, if the stock were to be registered, the registration would have to occur at the "worst" time for Frontier, because of Frontier's pending $20 million debenture offer.

Second, the value would be reduced by an additional 10% to 20% because RKO, the parent company, was the seller, and this might be construed in the market as the first step in a sell-out by RKO.

Third, the value would be reduced another 10% because Frontier common stock was selling at a P/E ratio of 80 times earnings and the company's immediate financial picture was not good, with earnings considerably lower than the year before.

Finally, even if the prospective purchaser knew that RKO would not continue to sell, the purchaser would know that he was in a permanent minority position with RKO holding 43% of the stock. Dugan testified that if it was made clear that RKO was not "bailing out," the discount from market price would still be about 33⅓%.

Dugan calculated that with a 50% discount from the high market price on September 18, 1967, the value of the block of Frontier securities was $6,725,315.75, or $824,766.75 less than the purchase price of $7,550,082.50. Thus, RKO had realized no profit.

RKO's computations indicate a realized profit of $520,296.40 using a 40% discount factor, and a realized profit of $1,417,005.16 using a 33⅓% discount factor.

On rebuttal, Dr. Bellemore disputed Mr. Dugan's analysis of Frontier's P/E ratio and testified that the American

Stock Exchange's ability to handle exchange and secondary distributions would enable it to handle a block of this size at or about the prevailing market price.

On the basis of the testimony, the court does not find that a discount factor should be applied to the market price of Frontier stock on September 18, 1967.[5]

Dugan was not testifying from the point of view of market value, which is the test under Section 16(b), *Blau* v. *Mission Corp.*, *supra*; *Stella* v. *Graham-Paige Motors Corp.*, 259 F.2d 476 (2d Cir. 1958), but from "investment value," which is more subjective, and more susceptible to individual variations because of an emphasis on one factor rather than another. Section 16(b) is concerned with as objective a valuation as possible, which is generally determined by the market value. *Blau* v. *Mission Corporation*, *supra*. Moreover, Dugan gave no weight to the previous history of sales of large control blocks of Frontier securities at prices above, not below, the market; see footnote 4, *supra*.

The sole remaining question is whether a premium for control should be added to the market price, which depends on whether the stock was worth more to RKO than the market price, to enable it to retain 56% control following the merger. Whether a premium should be added to market price to determine realized profit under Section 16(b) was considered in *Fistel* v. *Christman*, 135 F. Supp. 830, 832 (S.D.N.Y. 1955); and *Blau* v. *Lamb*, 242 F. Supp. 151, 160-1 (S.D.N.Y. 1965), *aff'd in part, rev'd in part*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

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[5] Plaintiff's expert, Dr. Bellemore, testified that he made an "investment value" analysis of Frontier and concluded that the investment value was very close to the market value and that no discount factor should be applied.

In *Fistel,* Judge Weinfeld valued 4,217 shares of Federal Enamel stock at no less than $140 per share. There, the expert witness testified as to market prices of several arm's length transactions in the period in question. Judge Weinfeld held that "this [value of no less than $140 per share] takes into account such premium, if any, which might have been paid to secure a large and controlling block of stock of a closely-held corporation," 135 F. Supp. at 832.[6]

In *Blau* v. *Lamb,* Judge Tyler held that a premium of $2.50 per share should be added to the book value of $6 per share of the Industries stock to reflect the added value of the stock because of the company's "recently recruited management team . . . and . . . [the] promising sales prospects . . . in the . . . industry," 242 F. Supp. at 160-161. However, Industries stock was not actively traded and there was no readily available market price from which to compute market value, as there is here.

Therefore, neither *Fistel* v. *Christman* nor *Blau* v. *Lamb* dictates that a premium should be added to market price.

Section 16(b) provides for the recovery of "any profit realized by . . . any purchase or sale . . ." In *Blau* v. *Mission Corp., supra,* the Court had to value a block of Development Corporation securities which had been issued and exchanged for a block of Tide Water securities. Prior to the transactions complained of, Mission Corporation (the insider) owned 36% of the outstanding stock of Development and the remaining 64% were publicly held. After the issuance of new stock and the exchange, Mission Corporation owned 63% of the stock of Development and the

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[6] It was not necessary for Judge Weinfeld to place an exact figure on the premium factor because in the circumstances of that case, any value higher than $140 meant that no profit was realized by the short-swing sale.

remaining 37% were publicly owned. The Court held that the value of the stock which was sold was equivalent to the value of the "consideration received," viz., the newly issued Development stock which gave Mission Corporation legal control, but that the stipulated market price of Development stock was not conclusive on market value and the court remanded for a hearing and new findings on the market value.

In *Stella* v. *Graham-Paige Motors Corporation, supra,* the Court was faced with the problem of valuing the tangible and intangible assets of an automobile manufacturer. The Court stated:

> "Many factors enter into value. The weight to be given to these factors involves the business judgment of the bargaining parties. . . . The fair value of large industrial properties cannot be fixed by the estimated price which might be received on the auction block in liquidation. *The best price would undoubtedly be offered by some company which had the greatest need for the property being sold.* Only when such a purchaser were found would the seller obtain the optimum value . . . Obviously no seller is going to become 'willing' [to sell] until he finds *the buyer who will pay the best price because of his belief that these particular assets will be peculiarly beneficial to him.*" (Emphasis added:) at 478.

The block of stock here involved was "peculiarly beneficial" to RKO, who had the "greatest need" for it. Hence, the market value on September 18, 1967 is not the sole criterion. The block was worth more to RKO because it represented the difference between its maintaining its 56% control of Frontier or having its ownership reduced to 43%.

Maintaining legal control of Frontier was important to RKO in preventing take-over bids by others, an increasingly common phenomenon in this day of conglomerates, and in assuring it of complete management control of Frontier.

In determining the amount of the premium over market value, the best evidence is what RKO had paid in the past to obtain and retain control of Frontier. RKO originally purchased control from Goldfield in 1964, and purchased treasury stock shortly thereafter. On those occasions, it paid a premium of 15% to 20% over the market price. It follows that the addition of a 15% premium to market price is reasonable in determining the value of the securities received by RKO under the merger.

Applying the 15% premium, the court finds that RKO sold the Central securities for $15,470,764., realizing a profit of $7,920,681. over its cost of $7,550,082.

Plaintiff applies for interest to be awarded from the date of RKO's "sale" of its Central securities. Interest should be denied in Section 16(b) cases "when its exaction would be inequitable." *Blau* v. *Lehman*, 368 U.S. 403, 414 (1962). While RKO "contracted with a small number of major Central shareholders to purchase . . . 49% of Central's outstanding shares, plus . . . debentures . . . [when] at the time of the execution of the purchase agreement, neither the public nor the shareholders of [Central and Frontier] had been informed of the proposed merger," 294 F. Supp. at 360, in view of the fact that Frontier stock is currently quoted at around 8 compared to 26 on September 18, 1967, the court feels that the exaction of interest would be inequitable.

The Clerk is directed to enter judgment in favor of Frontier for $7,920,681.58, and costs. Attorneys for plaintiff may apply to the court for a reasonable attorneys' fee.

Since the legal issues under Section 16(b) are novel and RKO has indicated that it will appeal Judge Tyler's determination that Section 16(b) applies, execution of the judgment will be stayed pending appeal.

Settle judgment on notice.

Dated: New York, N. Y.
September 22, 1969.

DUDLEY B. BONSAL
U. S. D. J.

APPENDIX D

Order Denying Rehearing

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

MARGOT NEWMARK,

Plaintiff-Appellee,

—v.—

RKO GENERAL, INC.,

Defendant-Appellant,

FRONTIER AIRLINES, INC.,

Defendant.

A petition for a rehearing having been filed herein by counsel for the appellant, RKO General, Inc.,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

IRVING R. KAUFMAN,
U. S. C. J.

WILFRED FEINBERG,
U. S. C. J.

EDMUND L. PALMIERI,
U. S. D. J.

June 2, 1970.

Order Denying Rehearing en Banc

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

MARGOT NEWMARK,

Plaintiff-Appellee,

—v.—

RKO GENERAL, INC.,

Defendant-Appellant,

FRONTIER AIRLINES, INC.,

Defendant.

A petition for a rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the appellant, RKO General, Inc., and no active circuit judge having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

J. EDWARD LUMBARD
Chief Judge

June 2, 1970.

APPENDIX E

Judgment of the Court of Appeals, Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirtieth day of April one thousand nine hundred and seventy.

Present:

HON. IRVING R. KAUFMAN,
HON. WILFRED FEINBERG,
Circuit Judges,
HON. EDMUND L. PALMIERI,
District Judge.

MARGOT NEWMARK,
Plaintiff-Appellee,

—v.—

RKO GENERAL, INC.,
Defendant-Appellant,

FRONTIER AIRLINES, INC.,
Defendant.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order and judgment of said District Court be and they hereby are affirmed with costs to be taxed against the appellant.

A. Daniel Fusaro/w
Clerk

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 477

RKO GENERAL, INC.,

Petitioner,

v.

MARGOT NEWMARK,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

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September 1, 1970

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Section 16(b) of the Securities Exchange Act of 1934 15 U.S.C. § 78p(b) .....2, *passim*

Section 249 of the Bankruptcy Act, 11 U.S.C. § 649 16

Section 414 of the Federal Aviation Act of 1958, 49 U.S.C. § 1384 .....17 note

IN THE

Supreme Court of the United States

October Term, 1970

No. 477

RKO GENERAL, INC.,

Petitioner,

v.

MARGOT NEWMARK,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

Counterstatement of Questions Presented

(1) Should an insider, who made a cash purchase of his issuer's securities and within six months exchanged those securities at a profit for securities of a different company in a merger, be exempt from Section 16(b) of the Securities Exchange Act of 1934 where the insider controlled the occurrence of the merger and was in possession of information unavailable to the general public, on the theory (a) that an exchange pursuant to a merger can never be a "sale," or (b) that the profit was not "realized" because the insider did not thereafter sell the second company's securities?

(2) Should this Court grant a writ of certiorari to decide a question which was not raised in or considered by the Court of Appeals, namely whether the CAB's approval of a merger of two airlines foreclosed the courts from finding that an insider violated Section 16(b) of the Securities Exchange Act of 1934 in the course of and incidental to such merger?

Statement of the Case

1. The Facts on Which the Judgment is Based

On May 3 or 4, 1967, petitioner RKO General, Inc. ("RKO") contracted to purchase a controlling block of securities of Central Airlines, Inc. ("Central"), knowing of a proposed merger of Central into Frontier Airlines, Inc. ("Frontier") (JA 258a, 404a).* On the same day Frontier, which RKO controlled through the ownership of 56 percent of Frontier's outstanding shares, entered into an agreement with Central, whereby Central was to be merged into Frontier, by an exchange of stock, the surviving corporation to be Frontier (JA 264a Ex "A" p. 1).

At the time that the purchase contract was executed, neither the public nor the outside shareholders had been informed of the proposed merger (JA 258a). The following day the financial press reported the proposed merger and for the first time it was also disclosed that RKO had contracted to purchase Central securities (JA 398a, 258a).

RKO's consummation of these two contracts (the "purchase agreement" and the "merger agreement") on September 18, 1967, resulted in the substantial profit in Central securities which the judgment below requires RKO to yield pursuant to Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b):

* "JA" refers to the Joint Appendix in the Court of Appeals.

The purchase contract fixed the price at which RKO could purchase the Central securities at $8.50 per share of common (JA 276a). It also assured shareholder approval of the merger for it obliged the majority shareholders of both corporations to vote in favor of the proposal (JA 277a, 264a, p. 3).

As the Court of Appeals observed:

> "RKO's contract to purchase Central shares is a classic example of trading while in the possession of information unavailable to the general public. * * * RKO was in an ideal position to take speculative advantage of [the] rise [in price occasioned by release of the proposed merger agreement] by purchasing Central securities at a price established in the purchase agreement before public disclosure of the proposed merger and disposing of these securities after disclosure had caused them to increase in value." (PA 7a-8a).*

Under the merger agreement, Central was to be merged into Frontier on the basis of an exchange of one share of Frontier common stock for each 3½ shares of Central common. The representatives of Frontier (RKO's subsidiary) were given "free and full access to the books and records of Central" (JA 264a Ex. "A" p. 4). It was also provided that the merger could be abandoned at any time prior to its effective date, whether before or after stockholder approval (JA 264a Ex. "A" pp. 7-8).

Consummation of the merger was conditioned upon approval by the Civil Aeronautics Board ("CAB"). However, if, in RKO's "good faith judgment" (JA 277a), the subsidy to be awarded to the surviving company by the CAB was inadequate or if any of the other conditions im-

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* "PA" refers to the Appendix annexed to the Petition.

posed by the CAB adversely affected the interests of RKO, Frontier or Central, the contract granted RKO the right to abandon the purchase and merger.

On September 1, 1967, the order of the CAB's hearing examiner approving the merger became final, subject to the acceptance by Frontier of the amount of the subsidy to the new company and the other conditions imposed upon the merger by the CAB. RKO thereafter "had the power to determine when or, for that matter, if the purchase and merger would take place" (PA 9a). RKO's favorable speculative posture was described by the Court of Appeals as follows:

> "RKO had no obligation to purchase the Central shares unless, in its 'good faith judgment,' the subsidy granted the merged airline by the CAB was satisfactory. It was thus in a position to maximize its speculative gain in Central shares by withholding its expression of satisfaction with the subsidy until the rise in the price of both Central and Frontier shares fully reflected the impending merger. At the same time, it should be clear that RKO's power to reject the subsidy would have enabled it to escape any possible loss in Central securities." (PA 9a).

On September 18, 1967, RKO consummated its purchase of Central securities by delivering its check for $7,550,082.50 to the selling stockholders. On the same day, the merger agreement was filed with the Secretary of State of Nevada, effecting the merger (JA 239a). RKO thereby exchanged its Central securities for a control block of Frontier securities, valued by the courts below at $15,470,764 (PA 50a).

2. Proceedings Below

a. The District Court

In an opinion and order dated December 6, 1968, the District Court for the Southern District of New York

(Tyler, J.) denied RKO's motion for summary judgment and granted plaintiff's cross-motion for partial summary judgment on liability.

Thereafter, a trial on the issue of damages was held before Judge Bonsal. He found that RKO realized a profit of $7,920,681.58, representing the difference between the cash purchase price paid by RKO for its Central securities and the value of the Frontier securities received by RKO on the merger, which included the control value of the Frontier securities. On October 2, 1969, he entered judgment accordingly.

b. *The Court of Appeals*

On RKO's appeal, the judgment of the District Court was unanimously affirmed by the Court of Appeals for the Second Circuit.

In its opinion, the Court of Appeals held that RKO's purchase and subsequent exchange of Central securities for securities of Frontier lent itself to speculative abuse in at least two ways:

> "In sum, the purchase and subsequent exchange of Central shares were fraught with opportunities for the kind of speculative abuse section 16(b) was intended to abort. RKO's success in fixing the purchase price before the proposed merger became public knowledge opened the door to possible speculative gains. Its ability to determine whether and when the merger would be consummated enabled it to maximize these gains or, at the very least, to avoid any loss." (PA 9a)

The court then addressed itself to RKO's contention "that the exchange did not fundamentally alter the nature of its holdings and therefore that it cannot fairly be characterized as a sale," which contention, the Court noted, relied on

"the 'economic equivalence' test of *Blau* v. *Lamb*, [363 F.2d 507 (2d Cir. 1966)], where we held that the conversion of preferred stock to common stock was not a sale under 16(b) since 'that which the insider [surrendered] and that which he [received were] simply different forms of the same participation in his issuer.' 363 F.2d at 523." (PA 10a-11a). The court responded that *Lamb* itself had declared the principle which renders the "'economic equivalence' exemption * * * inapplicable to this case":

> "The doctrine of economic equivalence is applicable only to exchanges involving the securities of a single issuer; we stated clearly that 'sales or purchases by an insider of his issuer's securities for cash, *the securities of a different company*, or other property are within the reach of Section 16(b) * * *.' 363 F.2d at 523 (emphasis added). When RKO exchanged its Central shares for Frontier securities it received 'the securities of a different issuer,' which represented ownership rights in the new merged airline." (PA 11a) (emphasis in original).

RKO's contention that it had not realized any profit was thus rejected:

> "Whether, upon divestment, the insider receives cash or property should be immaterial; if the statute is to achieve its end what is significant is that he has attempted to turn a short swing in the price of his issuer's securities to his own personal advantage. RKO purchased Central securities for some 7.5 million dollars. In return for these securities, it received Frontier shares worth more than 15 million dollars. The receipt of these shares was a sufficient realization of profit to place the transaction within the scope of section 16(b)." (PA 12a-13a).*

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* The Court also held that RKO became a 10% "beneficial owner" and hence an insider of Central prior to its purchase of Central securities (PA 14a).

RKO filed a petition for rehearing en banc which was denied without dissent (PA 53a).

ARGUMENT

I. The Petition Raises No Question of General Importance

The circumstance that this "case involves by far the largest monetary judgment ever entered in a Section 16 (b) case" (Pet. p. 16) is not the variety of importance which justifies the granting of the Petition. Recognizing this, petitioner has sought to give the case an aura of importance by recasting the transactions on which its liability is based so as to raise issues not presented by the facts and to give the appearance of a conflict in the decisions which does not exist. In fact, no court has ever held that mergers or exchanges of shares of different companies are outside 16(b).

a. This Case Involves Unique Facts

Warning of "distortions in important commercial transactions affecting thousands of shareholders" (Pet. p. 18), RKO urges the Court to relieve it of liability by exempting all mergers from 16(b). (Pet. p. 23). The judgment below does not jeopardize "ordinary, perfectly proper commercial transactions" (Pet. p. 18). Nothing that was decided below would interfere with run-of-the-mill mergers.

The decision below is based on the unique transactions involved here. The Court concluded that RKO's purchase prior to the merger and its subsequent exchange of Central shares "were fraught with opportunities for the kind of speculative abuse section 16(b) was intended to abort" (PA 9a). RKO was found liable because this particular statutory merger was a product of interrelated "purchase and merger

agreements" which RKO could abandon or consummate and which therefore "placed RKO in a position which must be the dream of every speculator—'Heads I win, tails I do not lose.'" (*ibid.*).

As the court below held (PA 8a-9a), these agreements not only enabled RKO to purchase Central securities at a price established prior to the disclosure of the proposed merger and to avoid the purchase if subsequent events were to make the merger unprofitable for RKO, they also gave RKO inside knowledge of the affairs of Central and control over the timing and ultimate fate of the merger.

Moreover, the Central shareholders were subject to risks not attendant upon the ordinary statutory merger. A merger is usually consummated once it has been approved by the shareholders of the constituent corporations. Even where the parties retain the right to abandon the merger, ordinarily the insiders of each corporation make independent judgments as fiduciaries on behalf of the shareholders of each corporation. But here, RKO was empowered to make that decision for both sides because the dominant Central shareholders had surrendered to RKO in the purchase agreement control over the fate of the merger. Thus, RKO could have made its decision to purchase and merge or not to purchase and merge for considerations beneficial to itself rather than in the interests of the public Central stockholders.

Even as the ordinary statutory merger does not necessarily create the possibility of speculative abuses, neither does it of itself contain all of the elements necessary before liability can attach under Section 16(b). If the transaction herein involved only a statutory merger of Frontier and Central without any purchase of Central securities within

six months thereof, as petitioner's questions imply, there would have been a "sale" of the Central securities by their exchange into Frontier shares but no "purchase" of the Central securities.

Thus, the decision below establishes no general principle that statutory mergers will always be covered by Section 16(b). On the contrary, it is RKO which must seek to exempt all statutory mergers from 16(b) (Pet. pp. 2, 23), since no narrower rule would relieve it of liability.

b. No Conflict of Decisions Exists

Petitioner asserts that the decision below is in conflict with this Court's decision in *Blau* v. *Lehman*, 368 U.S. 403, and with those of various Courts of Appeals (Pet. pp. 17 *et seq.*).

RKO's reliance on *Blau* v. *Lehman*, involving the question of deputization of a director, is based not on anything that was there decided, but on an asserted difference in "approach" between this Court's opinion and the decision below (Pet. pp. 18, 23). No inconsistency appears. The "reach of Section 16(b)" was not "limited" (Pet. p. 18) in *Lehman*; the Court simply held that it would not broaden the categories of persons on whom liability would be imposed when the statutory language and the legislative history of the statute established that Congress had deliberately declined to do so (368 U.S. at 411-12).

Nor is the decision below in conflict with decisions of other Courts of Appeals. No court has ever refused to apply 16(b) to a purchase and merger transaction, nor does the Petition point to any such decision. On the contrary, all cases which have dealt with the subject of exchanges of

securities of one issuer for the securities of another issuer whether by mergers or other types of exchanges have held that under 16(b) such exchanges and mergers constitute a "purchase" of the securities acquired and a "sale" of the securities surrendered. *Blau* v. *Mission Corp.*, 212 F.2d 77 (2d Cir. 1954), *cert. denied* 347 U.S. 1016; *Booth* v. *Varian Associates*, 334 F.2d 1 (1st Cir. 1964), *cert. denied* 379 U.S. 961; *Marquette Cement Mfg. Co.* v. *Andreas*, 239 F.Supp. 962 (SDNY 1965); *Blau* v. *Hodgkinson*, 100 F.Supp. 361 (SDNY 1951).

Striving to create a conflict in the decisions where none exists, RKO attempts to confuse this transaction, involving an exchange of securities of two different corporations, with *intracorporate* transactions such as conversions and recapitalizations. Where, as here, the securities of different corporations are exchanged, the fact that the securities surrendered and received represent investments in different enterprises with different risks and opportunities and the fact that the insider is no longer subject to the market risks in the securities surrendered, compel the conclusion that such exchanges are purchases and sales.

Although there is no conflict among the Circuits with respect to the issues raised by this case, a division in *approach* has grown up between a "pragmatic" and an "objective" test under Section 16(b). Under the "pragmatic" approach, the courts have adopted the standard stated in *Ferraiolo* v. *Newman*, 259 F.2d 342, 345 (6th Cir., Stewart, J.):

> "Every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16(b)."

That standard was distilled from the decisions of the Second Circuit (see 259 F.2d at 344-45) and has also been applied by the Eighth and Ninth Circuits.* Under the "objective" approach, analysis of the possibility for speculative abuse is unnecessary, and a purchase and sale is found whenever a transaction comes within the literal meaning of these terms. This approach is illustrated by *Heli-Coil Corp.* v. *Webster*, 352 F.2d 156 (3d Cir. 1965), where it was held that the conversion of convertible debentures into common stock of the same company constituted a "sale" of the debentures and a "purchase" of the common under 16(b) even though the securities were economic equivalents. These are the "somewhat conflicting approaches to § 16(b) by the Court of Appeals" which Mr. Justice (then Judge) Blackmun's dissent in *Petteys* v. *Butler* (Pet. p. 22) urged this Court to resolve. This Court nonetheless denied certiorari, *sub. nom.* in *Blau* v. *Petteys*, 385 U.S. 1006, and simultaneously in *Blau* v. *Lamb*, 385 U.S. 1002, which had been decided by the Second Circuit, 363 F.2d 507. No intervening change in the law has occurred.

The instant case involving an exchange of securities of two separate companies is not an appropriate vehicle to resolve the differences between these two approaches. RKO's liability has been adjudged under the approach which is the more lenient to insiders, namely, the pragmatic approach which relieves the insider from liability where there exists no possibility of speculative abuse. Thus, this case presents no occasion for determining whether the pragmatic or objective approach to 16(b) is correct: the outcome herein could not be affected.

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* *Petteys* v. *Butler*, 367 F.2d 528 (8th Cir. 1966), *cert. denied* 385 U.S. 1006; *Blau* v. *Max Factor & Co.*, 342 F.2d 304 (9th Cir. 1965), *cert. denied* 382 U.S. 892. See also the discussion of these cases by Judge Tyler in the District Court (PA 25a-26a).

II. The Judgment Below Was Correct

Part II of the Petition (pp. 26-39) is nothing else than an elaborate reargument of the merits of the case. This case raises no question of general applicability, let alone importance; review would be unwarranted even if the judgment below were arguably wrong. That the judgment was correct appears most clearly from the opinions of the District Court and the unanimous Court of Appeals.

A. The basic thesis of the Petition is that RKO engaged in a "single investment transaction" (Pet. p. 26), namely, an investment in "Central-Frontier securities." * As the point is stated at Pet. p. 31:

> "Essentially there was but one transaction. It was immaterial as a practical matter whether the merger took place before the stock purchase or vice versa. In either case, the ultimate result was the same: RKO was purchasing Central-Frontier securities."

RKO's representations to the Internal Revenue Service were otherwise:

> "There were two separate and wholly unconnected objectives involved in the total proposal: the desire of RKO to acquire some Central shares as an investment, and, second, the merger of the two airlines.
>
> * * * * *
>
> "It is submitted that the two separate transactions involved, i.e., the merger and the stock purchase, were both motivated by clearly bona fide business purposes and neither had as its principal purpose the reduction of Federal taxes." (JA 356a-357a).

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* Since RKO refers throughout to "Central-Frontier securities," we note, at the risk of belaboring the obvious, that no such securities ever existed, and there has never been a "Central-Frontier" company. While RKO seizes on Judge Tyler's reference to post-merger Frontier as "Central-Frontier" (Pet. p. 5, n. 1), he did so only "[f]or convenience" (PA 19a).

This recasting of the transactions in the Petition, which is designed to foster the illusion of a single, long-term investment in Frontier, short-circuits the purchase of the Central securities pursuant to the purchase agreement and the sale of the Central securities pursuant to the merger agreement.

B. Additionally, RKO contends that when it purchased Central securities its only purpose was to purchase securities of the merged company and that it was not motivated by profit when it entered into the transaction (Pet. p. 29). This contention ignores the fact that 16(b) applies irrespective of the insider's motive or intent. The principle which governs decision under 16(b) is stated by Chief Justice (then Judge) Burger in *Adler* v. *Klawans*, 267 F.2d 840, 845 (2d Cir. 1959):

> "Unlike a criminal statute where intent would be an essential ingredient this statute renders the subject accountable for proscribed profits regardless of intent."

C. In order to establish that it "never realized any profit," RKO contends that the Central shares it purchased were the "economic equivalent" of "the securities of the merged company" asserting that the Court of Appeals did not explain why they were not (Pet. p. 36). This is not so (PA 10a-11a). The Court of Appeals' explanation was that Central and Frontier securities were not economically equivalent because they represented ownership in two different corporations.

The total assets of Central, as of April 30, 1967, were $14,557,000; the total assets of Frontier were $62,760,000 (JA 324). Thus, while the Central shares which RKO purchased represented ownership in a corporation with assets of less than $14.6 million, the Frontier securities

which it received in exchange on the merger represented ownership of a company with assets of more than $77.3 million. Again, Central's income in the year April 30, 1967, was $557,131; Frontier's income was $1,632,842 (JA 323). Frontier estimated that its post-merger net income would be $3.2 million (JA 327a); almost six times as much as Central's income had been.

We submit that these figures do not represent merely "a theoretical distinction between corporate entities"; but significant "facts of real economic" differences (Pet. p. 37). Indeed, this Court has determined that an investment in one company differs materially from an investment in some other company into which the first has merged. *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 467.

Since the securities exchanged here were found not to have been "economic equivalents," RKO's reliance (Pet. p. 37) on the opinion of four of eight judges in *Heli-Coil Corp.* v. *Webster, supra,* that no profits were realized upon the exchange of economically equivalent securities of the same corporation, is misplaced.*

RKO's suggestion that 16(b) liability can result only if the insider receives cash is without merit. As one court said in a 16(b) case:

> "'Profits are realized by sales or exchanges in which the value received is greater than the cost . . . of the thing parted with. It is not necessary that the profit be realized in cash; profits are regarded as realized if cash *or property* is received in the transaction' . . . We cannot believe that any accountant or legislator

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* As noted, the transaction referred to in *Heli-Coil* involved the conversion of convertible debentures into common stock of the same company, a transaction since exempted by Rule 16b-9, 17 C.F.R. § 240.16b-9 (1966), and having no counterpart in this case.

either would dispute this statement . . ." (emphasis supplied).*

RKO further argues (Pet. p. 20) that in order for a profit to be realized the property received must be "a cash equivalent" which it defines as "readily marketable securities." RKO asserts that it could not have sold the Frontier securities it received in exchange for its Central securities because of certain investment representations. Those representations meant only that RKO could not have made an unregistered public distribution. Indeed, in the District Court, RKO admitted that being in control of Frontier it could have compelled Frontier to register the securities or it could have sold the securities in a private placement (JA 130a, 138a, 151a-152a).

In any event RKO's argument that the property received must be a "cash equivalent" is not correct. For example, the receipt of a non-assignable promissory note for its Central securities having a value equal to that of the Frontier securities it actually received would not have exempted the transaction from 16(b) liability. RKO's insistence on cash on the sale side of a 16(b) transaction would open a gaping hole in 16(b).

RKO's predicate that 16(b) liability only attaches if the judgment can be paid "from sources related to the transaction" (Pet. p. 20) is without authority. Indeed, Judge Learned Hand affirmed a judgment which necessarily had to be paid from sources unrelated to the transaction when he held an insider liable for a series of purchases and sales which had resulted in a net loss. *Gratz* v. *Claughton*, 187 F.2d 46, 51 (2d Cir. 1951), *cert. denied* 341 U.S. 920.

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* *Dabney* v. *Atlas Corp.*, CCH Fed. Sec. L. Rep. ¶ 90,651 ('54-'56 decs.) (SDNY 1954).

RKO also denies that it realized a profit because the Frontier securities have declined in market price since September 18, 1967 (Pet. p. 37). However, the courts below were concerned with speculation in Central securities—not Frontier securities. By disposing of its Central securities, RKO terminated its market risk in Central securities and assumed the market risk of Frontier securities.

D. RKO not only camouflages the critical steps of the purchase and sale of Central securities, it also ignores the fact that the transaction illustrates several of the abuses which Congress sought to eliminate. In *Wolf* v. *Weinstein*, 372 U.S. 633, this Court made clear that one of the evils at which Section 16(b) was aimed was the temptation of insiders to affect or influence corporate policy for the benefit of their own securities holdings despite detriment to other interested groups (see *id.* 642). *Wolf* involved a corporate reorganization and arose under § 249 of the Bankruptcy Act, 11 U.S.C. § 649. This Court stated that:

> "Congress enacted two distinct types of sanctions to prevent these possible practices. One appears in §16(b) of the Securities Exchange Act, 15 U.S.C. §78p(b), which prohibits the realization by insiders of short-swing profits from trading in their corporation's stock, even when the corporation is solvent." (*Id.* at 643).

The Court of Appeals recognized RKO's "tempt[ation] to affect or influence corporate policies * * * for the benefit of [its] own security holdings" (*id.* at 647), for it found that one of the speculative abuses present here was that RKO had been placed in a position where it could, for its own benefit, cancel the merger even though it was advantageous to the public Central shareholders.

E. Petitioner's reliance (Pet. p. 34) on disclosure of the merger and stock purchase agreements in proxy statements to the Central and Frontier shareholders, and their approval of the merger "is no more than a red herring." *Cf.* PA 8a. Disclosure of a 16(b) violation does not cure the violation. Moreover, such disclosure as was here made was meaningless since the requisite majority approval of the merger was pre-ordained. See p. 3, *supra*. Nor, indeed, did the proxy statements constitute full disclosure of the entire transaction, for they did not disclose the terms of RKO's purchase agreement or even that approval of that agreement by the CAB was a prerequisite for the accomplishment of the merger.

F. RKO urges that there was no possibility of the speculative abuses at which Section 16(b) was aimed because the CAB said that the merger and purchase terms were "not unfair" and would have "no adverse effect on" shareholders or others. This contention, which appears in RKO's third question presented, was not advanced below,* and is therefore subject to the rule recently reiterated in *Adickes v. Kress & Co.*, 398 U.S. 141, 147, n. 2:

> "Where issues are neither raised before nor considered by the Court of Appeals, this Court will not ordinarily consider them. *Lawn* v. *United States*, 355 U.S. 339, 362-363, n. 16 (1958); *Husty* v. *United States*, 282 U.S. 694, 701-702 (1931); *Duignan* v. *United States*, 274 U.S. 195, 200 (1927)."

No reason appears why an exception should be made here. Adherence to that rule is particularly appropriate since

* The only issue raised by RKO in the District Court was that §414 of the Federal Aviation Act exempted the transactions herein from §16(b) of the Securities Exchange Act. This contention was rejected by Judge Tyler (PA 33a-35a) and was abandoned in RKO's brief in the Court of Appeals.

RKO argues that the lower courts should have given the CAB's findings conclusive effect (Pet. p. 39).

In any event, the point is without substance. That the CAB plays no role in the administration of the Securities Exchange Act hardly requires comment. Further, the CAB never considered or made findings regarding RKO's short-swing profits; nor did it purport to determine whether RKO used inside information in connection with its decision to consummate the merger. Thus, no collateral attack on any findings of the CAB was made below. The discharge of the CAB's functions under the Aviation Act of 1958 was complete when it permitted the merger of the two airlines. Nothing that was decided by the CAB could relieve the courts below of their responsibility to apply Section 16(b) to the facts of this case.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for certiorari should be denied.

Respectfully submitted,

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONER'S REPLY BRIEF

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September 10, 1970

IN THE

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONER'S REPLY BRIEF

Respondent concedes that:

(a) The $8 million Section 16(b) judgment below is without precedent (Brief for Respondent in Opposition ("Brief in Opp."), p. 7).

(b) RKO realized no cash or cash equivalent profit as a result of the transaction in issue (*id.*, p. 15).

(c) RKO would face no possibility of Section 16(b) liability if, on the day of the Central-Frontier merger and stock purchase, the merger took place before the stock purchase. (Respondent bases her Section 16(b) case upon a "which came first?" dissection of a single transaction. If, on September 18, 1967, the merger came first, RKO would face no Section 16(b) liability; but since the stock purchase came first, says Respondent, RKO is liable for $8 million. (*Id.*, pp. 4, 5, 7, 8-9, 16.))

However, Respondent asks this Court not to consider the fundamental federal securities issues raised by this case because, Respondent contends, Section 16(b) merger cases such as the one at bar are unlike the Section 16(b) conversion and recapitalization cases on which the Circuit Courts are in disagreement (*id.*, p. 10). Additionally, Respondent asserts, the merger case at bar is unlike any other merger case (*id.*, pp. 7-8). Neither of these propositions is tenable.

1. This Section 16(b) merger case raises the same Section 16(b) definitional issues ("purchase and sale", "profit realized") as the Section 16(b) conversion and recapitalization cases on which the Circuit Courts are in disagreement (see Petitioner's Petition for a Writ of Certiorari ("Petition"), pp. 18-19, and Brief in Opp., pp. 10-11). The Court of Appeals below certainly thought so. The Court of Appeals relied upon the Second Circuit decision in *Blau* v. *Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967), a conversion case (see Petition, pp. 3a, n. 2, 4a, 10a-11a, 13a, 17a), and explicitly "rejected" the conflicting rule of the Third Circuit, as stated in *Heli-Coil Corp* v. *Webster*, 352 F.2d 156 (3rd Cir. 1965), another conversion case (Petition, p. 3a, n. 2; see also p. 12a).

Reliance by the Second Circuit upon conversion cases is understandable. Corporate reorganizations, whether by way of merger or conversion or reclassification of securities, merit different Section 16(b) treatment than ordinary cash purchases and sales of securities. And reorganization cases, whether involving mergers or conversions, raise identical Section 16(b) "purchase and sale" and "profit realized" definitional questions. For purposes of these questions, which are before this Court here, it makes no differ-

ence whether the reorganization is intra-corporate or extra-corporate.

Mr. Justice (then Judge) Blackmun has noted that the Circuit Courts are in conflict on these fundamental Section 16(b) questions. *Petteys* v. *Butler*, 367 F.2d 528, 539 (8th Cir. 1966) (dissenting opinion), *cert. denied*, 385 U.S. 1006 (1967). The case at bar provides this Court with a most appropriate opportunity to resolve this conflict.

2. The Central-Frontier merger was a typical corporate merger. Respondent asserts that the Central-Frontier merger was unlike all other mergers because a purchase of securities was a part of the deal (Brief in Opp., pp. 8-9). It is quite true that the Central-Frontier merger was dependent upon RKO's stock purchase and vice versa. However, this arrangement is hardly unusual. Quite frequently corporate mergers are coupled with contemporaneous stock purchases, usually buy-out purchases from the controlling shareholders of one of the merging corporations.

The decision below creates great uncertainty in the business community with respect to such mergers and real danger of huge insider liability. In the present uncertain state of the law, mergers in the interest of the shareholders involved (as the Central and Frontier shareholders overwhelmingly agreed here) and in the public interest (as the Civil Aeronautics Board ("CAB") found here) might nevertheless produce enormous insider penalties if the stock market happens to jump at merger closing time.

This Court, rather than the Circuit Court, should determine if ordinary, desirable commercial transactions are to be burdened with such incalculable potential liability.

3. Respondent's Section 16(b) case is based upon the supposed "purchase and sale" of *Central* securities (Brief in Opp., pp. 8-9, 16). Respondent would thus apply Section 16(b) liability to half of a transaction.

RKO was in fact purchasing *Central-Frontier* securities. Central securities were purchased only for immediate conversion into Central-Frontier securities. The undisputed purpose of the purchase was to allow RKO to maintain its controlling interest in Central-Frontier, the merged company (Petition, p. 7). As the Court of Appeals found (Petition, pp. 11a-12a, n. 5), RKO was obliged upon receipt of the Central securities to convert them by merger into Central-Frontier securities. And respondent does not and cannot suggest that RKO has ever "sold" its Central-Frontier securities. The Central-Frontier securities received pursuant to such conversion, on the very day of the purchase, are still held by RKO.

4. Respondent's theory of speculative abuse relates neither to a Section 16(b) "purchase and sale" nor to any Section 16(b) "profit realized."

Respondent contends that RKO was in a position to engage in speculative abuse of the sort proscribed by Section 16(b) because prior to September 18, 1967 RKO could have elected to perform the merger and stock purchase or to back out of the merger and stock purchase (Brief in Opp., pp. 8, 16).

However, Section 16(b) applies not to a purchase or no purchase, but to a "purchase *and sale*," an in-and-out trade (see Petition, pp. 26-27). Here there was none.

RKO got "in" and never got "out." (See Petition, pp. 30-32.)

No matter which way RKO decided to go, there was no opportunity for speculative abuse[1] in connection with an in-and-out Section 16(b) purchase and sale. If, as Respondent hypothesizes, RKO decided to call off the merger and stock purchase, there would have been no purchase and no sale—neither an "in" nor an "out" transaction—and, of course, no "profit realized." By performing the merger and stock purchase, RKO made a purchase but no sale; RKO came "in" and never went "out." And by making a long-term investment in Central-Frontier which is yet to be liquidated, and which could be liquidated today only at a loss (Petition, p. 13), RKO again has "realized" no "profit." The Second Circuit's contrary conclusion, which conflicts with the Third Circuit's decision in *Heli-Coil Corp.* v. *Webster*, 352 F.2d 156 (3rd Cir. 1965), and with any economic or common sense definition of "realized profit," surely merits this Court's reexamination.

5. Respondent erroneously represents that Petitioner's final argument—that Section 414 of the Federal Aviation Act, 49 U.S.C. § 1384, forecloses Section 16(b) liability

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[1] In discussing the opportunity for speculative abuse, Respondent states that the proxy statements to the Central and Frontier shareholders did not disclose the terms of RKO's purchase agreement or that approval of the agreement by the CAB was a prerequisite to the merger. (Brief in Opp., p. 17.) This was not the case. The proxy statement disclosed the essential terms of the purchase agreement (J.A. 264a, Ex. A, p. 3), contained the full text of the merger agreement (*id.*, Ex. "A"), and noted that performance of the merger was conditional upon CAB approval (*id.*, p. 5).

Respondent also impliedly criticizes the absence of any public announcement of the merger or stock purchase agreements until the day of the merger and stock purchase agreements (Brief in Opp., p. 2). These agreements were executed as of May 4, 1967, and were publicly announced the very same day (Petition, p. 8). No law or government regulation required any public announcement any earlier.

here—was not raised in the Court of Appeals below. Respondent concedes that RKO made this argument in the District Court (Brief in Opp., n. at p. 17) but suggests that this argument was not advanced in the Court of Appeals (Brief in Opp., pp. 17-18). This is not so. RKO's Section 414 argument was made to the Second Circuit on petition for rehearing.[2]

Thus, it is entirely appropriate for RKO to contend here that Section 414 entrusts the CAB with exclusive authority to approve all aspects of airline mergers and related transactions. The CAB is not merely entitled to exercise such authority; it is obliged to do so. In *Schwabacher* v. *United States*, 334 U.S. 182 (1948), this Court had occasion to interpret an analogous statute, Section 5 of the Interstate Commerce Act, 49 U.S.C. § 5, which empowers the Interstate Commerce Commission ("ICC") to approve and authorize mergers. This Court noted that the ICC's authority to approve mergers was "plenary and exclusive and independent of all other state or federal authorities" (*id.*, at 197). *Schwabacher* confirmed that ICC approval of a merger necessarily includes approval of the terms thereof and their effect upon shareholders and others, and that such approval, while reviewable upon appeal of the ICC proceedings, forecloses any collateral claims based upon any law other than the ICC merger statute.

CAB approval of an airline merger has the same effect. Section 414 of the Federal Aviation Act obliges the CAB to examine all aspects of the proposed airline mergers, including impact upon shareholders. And the CAB's ap-

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[2] This argument was made at pages 6-7 of the Petition of Defendant-Appellant RKO General, Inc. for Rehearing or, Alternatively, for Rehearing En Banc.

proval of an airline merger and the terms thereof cannot be overturned at some later date in a collateral proceeding.

Accordingly, we submit, a Section 16(b) claim cannot properly be based upon any transaction approved by the CAB pursuant to Section 414. Any such claim constitutes a collateral attack upon the CAB's authority with respect to airline mergers. Here, for example, the CAB approved the merger and related $7.5 million stock purchase, specifically finding that the terms of the merger and stock purchase were not unfair "to either carrier, the stockholders of each, the Federal Government, or the general public." (J.A. 317a.) The $8 million judgment below would more than double the stock purchase price approved by the CAB, thereby drastically changing the merger terms approved by the CAB.

The CAB's authority over airline mergers pursuant to Section 414 would be substantially derogated if the terms of a merger could be overturned *ex post facto*, without CAB scrutiny or approval, by means of a minority shareholder Section 16(b) action.

CONCLUSION

The questions raised by this case are fundamental securities questions of great public importance. Corporate mergers, securities reclassifications and other types of corporate reorganizations are vitally affected by them. At present there are no answers to these questions upon which businessmen and their lawyers can confidently rely. The Circuit Courts are in disagreement. The economic cost of such uncertainty is very high, as the $8 million judgment here attests. Review by this Court is urgently required.

Respectfully submitted,

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Supreme Court, U.S.
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OCT 23 1970

IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 477

RKO GENERAL, INC.,

Petitioner,

—v.—

MARGOT NEWMARK,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR REHEARING

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ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR REHEARING

The Petitioner, RKO General, Inc. ("RKO"), respectfully moves this Court for an order (1) vacating its denial of certiorari, entered on October 12, 1970, and (2) granting the petition.

Grounds for Rehearing

Subsequent to the denial of Certiorari by this Court, the SEC (1) has denied RKO's Application for a Rule concerning the applicability of Section 16(b) to mergers and related stock purchases, and (2) has received an Amended Application for a Rule concerning the definition of "profit realized" for purposes of Section 16(b).

In light of these developments, the Court may wish to solicit the views of the SEC in considering this Petition for Rehearing.

On October 13, 1970, following this Court's denial of certiorari, the Securities and Exchange Commission

("SEC") denied RKO's Application for a Rule which would have exempted certain stock purchases in connection with corporate mergers from Section 16(b) of the Securities Exchange Act of 1934 (the "Act"). RKO had urged the SEC to adopt the proposed rule pursuant to the authority of the SEC to exempt by rule or regulation those transactions "not comprehended within the purpose" of Section 16(b).[1] The rule proposed by RKO would have applied retroactively and, if adopted by the SEC, would have exempted the transaction in issue from Section 16(b).

Denial by the SEC of RKO's Application for a Rule threatens to leave RKO without remedy to correct the improper application of Section 16(b) liability which was imposed by the courts below. Moreover, the SEC's action means that only this Court can authoritatively determine here how Section 16(b) should be applied to mergers and related stock purchases.

Subsequent to the SEC's October 13, 1970 denial of RKO's initial Application for a Rule, RKO was informally advised by a Commissioner of the SEC that the SEC may be willing to consider a rule relating to the definition of "profit realized", as that term is used in Section 16(b). No representations were made, of course, with respect to the action which the SEC might take on such a rule.

It is decidedly in the public interest to clarify the law concerning "profit realized" under Section 16(b). And on October 20, 1970, RKO filed with the SEC an Amended Application for Adoption of Rule (Appendix A hereto, pages 1a to 7a *infra*). In this Application, RKO has urged

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[1] Section 16(b) provides in pertinent part:

"This subsection shall not be construed to cover . . . any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

that, for purposes of Section 16(b), the term "profit realized" should be defined to mean any liquidated profit received in the form of cash or cash equivalent, when that term is applied to any transaction involving the purchase of securities in contemplation of and conditioned upon a statutory merger of the issuing company with another corporation. Such a rule would, of course, exempt transactions like the one in issue from Section 16(b).

RKO has urged that the proposed "profit realized" rule should be adopted retroactively. We cannot, of course, predict whether the SEC will adopt the rule proposed or whether that rule, if adopted, will apply retroactively.

Thus, unless this Court is advised to the contrary by the SEC, the basic Section 16(b) issues raised by this case can only be determined by this Court. As the Court will recall, in May 1967, RKO entered into a single business deal to purchase control of Central Airlines, Inc. ("Central") and to merge Central into Frontier Airlines, Inc. ("Frontier"), a company in which RKO then owned a majority interest. Thus RKO contracted to purchase shares representing a controlling interest in Central from several major Central shareholders *conditional upon* the merger of Central into Frontier. The merger was approved by the shareholders of both companies after full and accurate disclosure of all relevant facts (including the RKO stock purchase conditional upon the merger). After all necessary approvals had been obtained, the stock purchase and merger were executed on a single day.

Because the stock purchase came first on that day, the courts below held that there was a "purchase" of Central stock and then an immediate "sale" of that stock in exchange for the stock of Central-Frontier, the merged company. The Central stock, converted into Central-Frontier stock by operation of the merger, cost RKO approximately

$7.5 million; however, on the day of the merger and stock purchase, Central-Frontier stock was supposedly worth some $15.5 million to RKO. RKO has never sold or otherwise liquidated its holding of the Central-Frontier stock obtained on the day of the merger; nevertheless, the courts below held that RKO "realized" on that day a Section 16(b) profit of nearly $8 million, the largest judgment ever entered under Section 16(b).

The stock for which RKO paid $7.5 million in 1967 is still held by RKO and has a market value today of some $2.3 million. Rather than "realizing" any profit on the stock purchase and merger, RKO faces an actual loss of approximately $5.3 million—even if RKO is not required to pay the additional $8 million judgment imposed below.

Section 16(b) was designed to take the profit out of insider in-and-out trading. Here, however, RKO got "in" but to this day has not gotten "out." RKO made a Section 16(b) "purchase" but no Section 16(b) "sale"; moreover, RKO never "realized" any "profit" on the transaction.

In our Petition for a Writ of Certiorari, we urged that it is of great public importance for the Court to decide whether a corporate merger *cum* stock purchase gives rise to Section 16(b) liability. In view of the subsequent denial by the SEC of our Application for a Rule concerning mergers and related stock purchases, and in view of the uncertainty surrounding our Amended Application for a Rule concerning "profit realized," it is now of even greater importance that this Court hear and finally determine these issues. Mergers and related stock purchases are frequent, important commercial transactions. The decision below adversely affects such transactions in a manner never contemplated by the framers of Section 16(b).

This Court should grant certiorari.

CONCLUSION

For the reasons set forth above, as well as those contained in the Petition for Writ of Certiorari, Petitioner prays that this Court grant rehearing of the order of denial, vacate that order, grant the petition and review the judgment and opinion below.

Respectfully submitted,

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October 23, 1970

Certificate of Counsel

I, RICHARD J. WERTHEIMER, one of the counsel for the Petitioner, do hereby certify that the foregoing petition for rehearing is presented in good faith and not for delay and is restricted to the grounds specified in Rule 58(2).

RICHARD J. WERTHEIMER
Counsel for Petitioner

APPENDIX A

Administrative Proceeding
File No. .....

BEFORE THE

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

In the Matter of

RKO GENERAL, INC.
1440 Broadway
New York, New York 10018

Securities and Exchange Act of 1934

Amended Application for Adoption of Rule

On September 3, 1970, RKO General, Inc. ("RKO") filed an application, pursuant to Rule 4(a) of the Commission's Rules of Practice, requesting that the Commission adopt a rule exempting certain transactions from the operation of Section 16(b) of the Securities Exchange Act of 1934 (the "Act"). At that time there was pending before the Supreme Court a petition for certiorari filed by the applicant in *RKO General, Inc.* v. *Margot Newmark*. On October 12, 1970, the Supreme Court denied the applicant's petition for certiorari in that case. On October 13, 1970, the Commission denied the application of RKO for the requested rule.

Subsequent to such denials, the applicant was advised by Commissioner Richard B. Smith that the Commission may be willing to consider a rule relating to the defini-

tion of "profit realized" as that term is used in Section 16(b) of the Act. Commissioner Smith, of course, made no representations with respect to the action which the Commission might take on such a rule.

The applicant believes it to be decidedly in the public interest that the Commission have an opportunity to consider such a rule. Surely the result in *Neutmark* v. *RKO General, Inc.*, 425 F.2d 328 (2d Cir. 1970), in the Second Circuit indicates that a "profit realized" rule implementing the Commission's previously expressed policy on the subject would be quite timely. Accordingly, RKO by this Amended Application hereby requests, pursuant to Rule 4(a) of the Commission's Rules of Practice, that the Commission adopt a rule relating to the definition of "profit realized" as that term is used in Section 16(b) of the Act.

Section 3(b) of the Act provides that the Commission "shall have power by rules and regulations to define technical, trade, and accounting terms used in this title insofar as such definitions are not inconsistent with the provisions of this title." The proposed rule relating to the definition of "profit realized" as that term is used in Section 16(b) would, in effect, exempt certain transactions from the operation of that Section of the Act. Such a result would not, however, be inconsistent with the provisions of that Section.

Section 16(b) establishes an absolute rule that any profit realized by insiders from a purchase and sale (or sale and purchase) of a security within a six-month period shall be recoverable by the issuer. This rule was intended by Congress to prevent insiders from profiting through the unfair use of inside information. Recognizing, how-

ever, that under certain circumstances, the application of the Section may be unnecessary, harsh or inappropriate. Section 16(b) provides that it "shall not be construed to cover . . . any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

I. *The Proposed Rule*

The rule which we propose for adoption, pursuant to the sections cited above, would provide as follows:

> (a) For the purposes of section 16(b) of the Act, the term "profit realized", as applied to any transaction involving the purchase of securities in contemplation of and conditioned upon a statutory merger of the issuing company with another corporation, means any liquidated profit received in the form of cash or a cash equivalent.
>
> (b) Any transaction specified in paragraph (a) with respect to which there was no "profit realized" as defined in paragraph (a) shall be exempt from the provisions of section 16(b) of the Act, and no liability under that section shall arise with respect thereto.
>
> (c) This rule shall apply to any transaction occurring before or after the effective date of this rule.

II. *The Reasons Why the Rule Should be Adopted*

The reasons for the adoption of the proposed rule were discussed at length in the applicant's Application for Adoption of Rule filed with the Commission on September 3, 1970, to which the Commission is hereby referred. These reasons are best illustrated, however, by transactions involving the applicant in *Newmark* v. *RKO General, Inc.*, 294 F. Supp. 358 (S.D.N.Y. 1968), *aff'd*, 425 F.2d 348

(2d Cir. 1970), *cert. denied*, 39 U.S.L.W. 3142 (U.S. Oct. 12, 1970). In that case, the District Court and the Second Circuit held that Section 16(b) is applicable to the transaction described below. As previously noted, the petition for certiorari filed in the Supreme Court by the applicant with respect to that case has been denied. Applicant intends to file a petition for rehearing with the Supreme Court. However, the Supreme Court's action with respect to such a petition for rehearing cannot be predicted.

Applicant, RKO General, a wholly-owned subsidiary of the General Tire & Rubber Company, in May 1967 entered into a contract to purchase shares representing a controlling interest in Central Airlines, Inc. from several major Central shareholders at $8.50 per share, and to purchase an issue of convertible debentures at the same price, based on the shares into which the debentures were convertible. This stock purchase agreement was concluded at the same time as was an agreement providing for merger of Central Airlines, Inc. into Frontier Airlines, Inc., a company 56 percent of whose stock was owned by RKO, and the stock purchase agreement was conditioned upon the completion of the merger. The merger was conditional upon stockholder approval of both companies, which was obtained in full compliance with the Commission's proxy rules. The merger was also conditional upon the approval of the CAB which was also obtained.

The District Court and the Second Circuit held that the transactions executed on the same day constituted a "purchase" of the Central stock at $8.50 per share, and a "sale" of that stock in exchange for stock in the merged company. Since the Central stock purchased by RKO for some $7.5 million was exchanged for stock in the

merged company, which had on the closing date a value of some $15.5 million, the District Court held that RKO "realized" on that one day—the closing date—a profit of nearly $8 million for purposes of Section 16(b).

RKO continues to hold the investment in the merged company which it made on September 18, 1967, and its investment in that company today has a market value of some $2.3 million, an actual loss of approximately $5.2 million—even if it is not required to pay an additional $8 million judgment.

The applicant believes that the kind of transaction described above does not constitute the sort of insider trading which Section 16(b) was designed to prevent. The applicant realized no profit as a result of the transaction—in fact it sustained an actual loss. The proposed rule by defining "profit realized" to include only those liquidated profits received in the form of cash or a cash equivalent would clarify what was undoubtedly the intent of Congress with respect to Section 16(b) and would avoid such harsh inequities as those suffered by the applicant with respect to Section 16(b) liability.

The proposed "profit realized" rule would simply confirm the Commission's previously stated position on this question. In *Heli-Coil Corp.* v. *Webster*, 352 F.2d 156 (3d Cir. 1965), the Commission appeared as *amicus curiae* and argued that the securities conversion in issue produced no *liquidated* profit and, therefore, no "profit realized" within the meaning of Section 16(b). The Commission stated, at page 14 of its *amicus* brief:

> "When used with reference to investments, the term 'realized' generally refers to the *liquidation* of an investment position and the collection of whatever profit

> has accrued. Although in some situations the statutory purpose may require a broader concept, this is not such a case. In no real sense did Mr. Webster *liquidate* his position to collect a profit when he converted. . . . It is thus apparent that for market or speculative purposes the debenture was, at that time, substantially the economic equivalent of the common stock into which it was convertible. After the conversion, as before, Mr. Webster retained his investment position in the securities of Heli-Coil and whatever profits had accrued continued to be at the risk of the market and could disappear without 'realization' if the market price of the common were to decline substantially. In the parlance of investors, these profits continued to be 'paper' profits both before and after the conversion." [Emphasis added.]

We submit that the proposed rule, articulating the Commission's position and the *Heli-Coil* holding with respect to "profit realized", would be most timely. Since we cannot predict what action, if any, the Supreme Court will take concerning applicant's petition for rehearing, we urge that the proposed rule be adopted retroactively. In *Blau* v. *Max Factor*, 342 F.2d 304 (9th Cir. 1965), the Commission in its *amicus curiae* brief urged the retroactive application of Rule 16b-9 which was adopted some two years after the transaction in question. Relying primarily on *SEC* v. *Chenery Corp.*, 332 U.S. 194, 203 (1947), and *Addison* v. *Holly Hill Fruit Products, Inc.*, 322 U.S. 607 (1944), the Commission vigorously argued that such retroactive application was particularly appropriate where the transactions were of a type clearly not comprehended by the statute, to which, even in the absence of a rule, the statute might well not apply. In view of the circumstances in the present case,

the applicant urges, that under these well-established principles the proposed rule be adopted retroactively.

Respectfully submitted,

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